WHERE'S THE BEEF?

…What's a Revenue?

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"Where's the beef" was Wendy's national ad campaign in the mid 80's. It compared Wendy's large hamburger patty to other chain hamburgers with big buns, lettuce, tomato, onions, and little beef. In early 2000 many investors and analysts were asking the same question about corporate revenues. As multiple financial scandals unfolded, many involved corporate revenues, or actually the disappearance of revenues as a result of restatements. Since then a tidal wave of change has affected accounting for revenues at technology companies, revolving around "**when"** can revenues legitimately be recorded (or "booked").

When is it a "revenue"?

After training thousands of managers over the years, this question generates an incredible array of answers. Some managers believe it's when the customer sends a purchase order, some think it happens when an invoice is sent to customers, others feel that it's when the cash is collected. Prior to 2000, revenues were typically booked when the goods left the company's loading dock. In the accounting world this was known as "recognizing revenue at point of shipment". For the service side of the business Generally Accepted Accounting Principles (GAAP) ground rules calls for recognizing revenue after the service was rendered.

Needless to say, these revenue rules left room for much interpretation. The intense drive for revenue growth in the 90's, particularly in the technology sector, spurred many companies to push the boundaries of the rules. One frequently used revenue booster was channel stuffing, shipping goods to distributors at the end of the quarter, then booking the revenue, even though some of it would be returned later. A master of this technique was Compaq. If the distributor balked, then another tactic was to drive loaded trucks to the back of some parking lot, or maybe just drive them around the block for 24 hours. This met the old requirement that revenue could be recognized at point of shipment. Another favorite revenue generator was "holding the month open". Instead of closing the books at the end of June, shipments would continue during the first, maybe even second, week of July, with the revenue recorded in June. Finally, an extreme revenue booking game involved creating revenue by shipping non-existent inventory or by simply making up customer invoices. All of these are "generally unacceptable accounting practices".

On the service side, companies can recognize revenue once the service has been rendered. For example, a high tech consulting practice can record services provided to a customer through the end of the month, even though they may not have been billed by the end of the month. Any unbilled revenues are estimated (or accrued) based on billable hours. Another casualty of the 90's involved aggressive accounting for service revenues. Revenues for service contracts were booked on the front end, instead of spread over the life of the contract. Prepayments and deposits were recorded as revenue when the cash was received, not when the service was actually rendered. Xerox and IBM were both embroiled in controversy over their service revenue recognition practices.

The SEC's response

The most significant push for change came from the SEC's Office of the Chief Accountant in late 1999, to stem increasingly creative accounting practices. There were many underlying events that triggered the issuance of SEC guidance on revenue recognition. A study undertaken by the Treadway Commission, an independent private sector group, found that over one-half of all accounting fraud between 1987 and 1997 involved overstatement of revenues. While some of the financial "management" at companies like Enron were subtle and difficult to understand for the investing public, as the 90's drew to a close the games became more daring, with companies aggressively "managing" their numbers.

Behind "managing the numbers"

The fear of missing analyst forecasts for revenue growth and earnings was the real driver of this creative accounting. Unfortunately, resorting to accounting games meant that a company did not deal with their real problem. Revenue and earnings growth are normally missed due to fundamental underlying causes – competition and, in early 2000, a dot-bust economy. As companies under earnings pressure started playing accounting games, hiding fundamental problems by shuffling numbers, everyone in the organization failed to realize the pending crisis. Everyone continued to spend their budgets, travel to shows, and develop new initiatives. Eventually the problem caught up. When it did, the only alternatives left were lay-offs, sale of assets and organizational restructuring.

Conclusion: The brave new world

Today, revenues must be recognized at *point of delivery and after customer acceptance*. In effect this has stretched out the time it takes to record revenue by days, sometimes weeks. Similarly, services revenues must be recognized over the service period. On a 1 year service contract, the company can only recognize 1/12th of the total service contract revenue each month. If revenue on hardware sales is not recognized until it's been delivered to the customer and accepted, then any services associated with that sale are also delayed until delivery and customer acceptance can be verified. This includes implementation services and related consulting services tied to the sale of the hardware.

The same is true for many long-term consulting projects, such as custom software development projects, where there is a great deal of latitude to interpret what has been "delivered" to the customer.

All of this is bad news for companies wishing to "manage the numbers" in order to show strong revenue and earnings growth. But in reality service revenues should be looked at from a different perspective. The beauty of this revenue stream is that it's the gift that keeps on giving because it creates a foundation of revenue stability because of its long-term nature. The hardware sale has to be repeated every month, every quarter. Service contract revenue can be sold once and continues adding to revenues over the next year, two years, five years. Done right, it builds incredible customer loyalty, and more repeat revenues. So, "there's the beef".

About the Author

Gudrun Granholm is the CEO and Founder of Box One, Inc., a firm specializing in custom financial training, financial skill assessment and related financial consulting for "operational" professionals, managers and executives. Gudrun has devoted her career to helping managers quickly understand the financials from a strategic perspective. The training and consulting connects manager's decisions and actions with their impact on the financials and develops a "total company view". It allows communication across all levels of the organization through the use of a shared financial language using the Box One Model™ in order to drive optimal financial performance. Prior to founding Box One, Gudrun served in a variety of financial roles, from financial analyst, controller to CFO/CEO over a 25 year period, including The Washington Post Company and The Smithsonian. Her training and consulting includes engagements with Fortune 500 organizations, universities and associations. Gudrun received her BA from Harvard University and her MBA from Stanford University Business School. For more information you can reach Gudrun at:

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