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. The ad compared Wendy's large hamburger patty to other chain hamburgers with big buns, lettuce, tomato, onions, and tiny beef patties. 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, revolving around "**when"** can revenues legitimately be recorded (or "booked"). For the retailing community, the question also became "**what**" is revenue, a debate revolving around discounts, promotional and contract allowances.

When is it a "revenue"?

After training thousands of managers over the years, this question generates an incredible range of answers. Some managers believe it's when the customer sends a purchase order, some think it happens when an invoice is sent to the customer, others feel that it's when the cash is collected. Prior to 2000, revenues for *manufacturers and distributors* 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 *service* businesses the Generally Accepted Accounting Principles (GAAP) ground rules call for recognizing revenue "once the service has been rendered". And, for *retailers* it is typically "at point of sale".

A separate set of rules apply for certain types of revenues such as membership cards where the customer pays an annual fee. It goes back to the heart of "when" to recognize (or book) the revenue. Do you recognize revenue in the month the customer pays the membership fee or do you spread it out over the year? Since the membership card provides a benefit over a one-year period, the revenue must be spread out over the year and recognized 1/12th each month.

Needless to say, these broad revenue rules left room for much interpretation. The intense drive for revenue growth in the 90's, along with severe competition, caused some retailers to push the boundaries of the revenue rules. And, retailers have become more complex business entities. While they continue to sell product to customers at retail, many are also "manufacturers" with in-store bakeries, full-service deli operations, and branded product. As of January 2005 Kroger operated a total of 42 manufacturing plants including 18 dairies, 11 deli or bakery plants, 5 grocery product plants, 3 beverage plants, 3 meat plants and 2 cheese plants. Some retailers are also "service" organizations as a result of catering, slotting fees for product placement, fuel centers, to name a few. Services also include web-based grocery delivery such as Albertsons.com and servicing vanity and membership cards. This growing complexity in the retail business model means that revenue recognition is not as simple as it used to be.

What's A Revenue?

In recent years discounts have come under SEC scrutiny. Many retailers recorded discounts earned on preferred loyalty cards as *an increase in cost*, as opposed to a *reduction in revenue*. This was also done for membership discounts at checkout, showing the full retail as revenue and then adding the discount amount to cost of goods sold. The argument in favor of allowing both options pointed out that the gross margin dollars and profitability are exactly the same under both methods.

So what's the beef? In the past it was easy to "manage" the numbers, as evidenced in the following example:

	Retailer A 2005	**Retailer A 2006**	**Retailer B 2005**	**Retailer B 2006**
Gross Revenue (in 000's)	$150,000	$165,000	$150,000	$165,000
Less: Discounts	0	0	(20,000)	(22,000)
Net Revenue	**$150,000**	**$165,000**	**$130,000**	**$143,000**
Square feet (000's)	*195*	*195*	*195*	*195*
Sales per square foot	*$769*	*$846*	*$667*	*$733*
No. of stores	*100*	*100*	*100*	*100*
Comp. store sales	*$1,500*	*$1,650*	*$1,300*	*$1,430*
Net Revenue	$150,000	$165,000	$130,000	$143,000
Less: Cost of Goods Sold	(104,000)	(114,400)	(104,000)	(114,400)
Less: Discounts	(20,000)	(22,000)	0	0
Gross Margin	**$26,000**	**$28,600**	**$26,000**	**$28,600**
Gross Margin %	***17.3%***	***17.3%***	***20%***	***20%***

(Sales per square foot in this example assume a big box discounter.)

This game is all about sales per square foot and comparative store sales, some of the most respected gauges of a retailer's performance. The illustration shows two retailers with the same gross revenues and comparable square feet. But their treatment of discounts significantly impacts their *net revenue* (the "real" number reported to shareholders and the financial community). Retailer A appears to have significantly greater sales. Retailer A has sales per square foot and comparative store sales 15% greater than Retailer B.

While it's true that the actual gross margin is the same for both retailers, the gross margin percentage of Company B looks significantly better. In the end, if both methods are allowed, the numbers presented by various retailers and distributors are **not** comparable. A core requirement of GAAP is comparability of numbers. This means that numbers rolling up into various financial statement captions are the same across the industry so that investors can rely on a "fair presentation" of financial reports. All financial data presented in public documents must be comparable across the years, as well as across the industry. Otherwise, it is apples to oranges.

In the end the SEC's position is that discounts are not real revenue. If the sales force says the retail price is $50, but they're willing to discount it to $30, then the *"real revenue"* is $30. In short, there's no more beef generated by Retailer A, it just looks better because of an accounting illusion.

More "creative" revenues

Some retailers have used a number of other creative ways to increase their revenues. In-store rental arrangements represented an area for artificially showing higher revenues. What is revenue to the retailer from an in-store rental agreement? The retail dollars generated by the lease operator or the lease amount? If the retailer could record the total retail dollars generated by the jewelry operator, that's obviously much better than just the lease income paid by that operator. Intuitively most people would guess that the retail dollars generated by the lease operator is *revenue for the lease operator, not the retailer* leasing the space. The retailer is only entitled to claim the lease amount as revenue, along with any income due under a revenue or profit sharing arrangement.

As pointed out earlier, retailers have become more complex from a revenue standpoint, sometimes looking more like manufacturers, distributors or service providers. Transferring product from manufacturing to the retail stores is not real revenue for the company, just an inter-company transfer. When should a catering job be recognized? Once the food has been delivered. If the catering job includes serving the food, then it's after this part of the service has been completed. Another area where some retailers have managed their revenues is layaways, booking the sale at point of layaway, not at point of purchase. Some have recorded revenue from membership cards up front when the membership is paid, instead of over the membership period. Slotting allowances were booked when the product was first stocked, not when the product was sold.

Guilt by Association

Another large area of risk for retailers represents the pressure on their suppliers to meet market expectations for revenues and profits. This means that retailers are vulnerable to all of the many revenue games played by their suppliers. In the past this included traditional revenue boosters such as channel stuffing, shipping goods to retailers and distributors at the end of the quarter, then booking the revenue, even though some of it would be returned later. If the retailer or 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".

Occasionally the pressure to meet earnings created situations where retailers and manufacturers colluded to create revenues. Many creative revenue solutions revolved around the timing of revenue recognition. Three former Kmart executives and 5 vendors were indicted in 2004. The civil complaint alleged that the Kmart executives pressured some of their suppliers into signing misleading invoices involving promotional allowances to secure premium shelf space. Normally these allowances would be recognized when the retailer provides the "service", i.e. spread over the time of the actual promotion which took place in 2002. Instead, the misleading invoices meant Kmart booked all of the allowance in 2001.

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. 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. "Premature revenue recognition appears to be the recipe of choice for cooking the books … quipped Walter Schuetze, chief accountant in the Securities and Exchange Commission's Enforcement Division, in a recent speech. Revenue-recognition issues accounted for about 50 percent of fraud cases in a study by the Committee of Sponsoring Organizations of the Treadway Commission of 200 SEC probes" (CFO, November 1999).

Behind "managing the numbers"

The investment community rewards companies with high revenue growth and increasing profitability. There is also a premium paid for companies with predictable (or smooth) earnings. All of which has led many companies to attempt to "manage their earnings". And, in some cases there was the added pressure of the personal element – compensation tied to commissions and quarter or year-end bonuses.

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, 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, organizational restructuring, and in some cases bankruptcy.

Conclusion: The brave new world

Today, several of the favorite revenue games are gone. Discounts must be treated as a reduction in gross revenue. They are "un-revenue". Promotional and contract allowances must be recognized when the product is sold, not when the promotion runs. Slotting allowances are recognized when the product is sold, not when it's stocked. Gift card revenue is recognized when the customer makes a purchase, not when the gift card is paid for. Ditto for lay-aways.

As for manufacturers and distributors, revenues must be recognized at *point of delivery and after customer acceptance*. This nicely aligns with the criteria for recognizing service revenues – "when the service has been rendered". Similarly, service revenues must be recognized over the service period. On a 1 year membership fee, the retailer can only recognize 1/12th of the total revenue each month.

All of this is bad news for companies wishing to "manage the numbers" in order to show strong revenue and earnings growth or smooth earnings trends. For those companies that have stayed with more conservative accounting practices, this helps create a level playing field. It means that comparable store sales and sales per square foot are more accurately reflected across the retail industry. From the investor's point of view, this is all good news. The focus is on making sure that revenue numbers are *real and comparable.* 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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