18 April 2023

Croner-i Accountancy Daily

Revenue recognition: avoiding the accounting pitfalls

Neil Keenan, Partner, Forensic Risk Alliance

17 Apr 2023

During recessionary times, there is a greater risk of incorrect revenue recognition reporting in accounts, warn Neil Keenan and Trevor Wiles, partners, and Ben Walter, associate director at Forensic Risk Alliance

We are living in a time of profound economic uncertainty. Often, the conditions this creates lead to increased accounting-related fraud and financial reporting issues.

While there are signs that the rate of inflation may be slowing, prices continue to rise around the world. In addition, supply chains are facing severe disruptions, labour forces face great challenges, and interest rates set by central banks are ticking up, leading to elevated borrowing costs for companies.

Lenders are becoming more cautious after an extended period of Covid support measures and high levels of liquidity that have kept troubled companies afloat.

There is huge pressure on the management of large corporations to meet targets, and report revenue and EBITDA [earnings before income tax, depreciation and amortisation] results that exceed the expectations of stakeholders, as well as to report on a timely basis to meet market deadlines.

These conditions perpetuate incentives and pressure on company sales and finance staff to engage in misconduct and misreporting of financial results.

Inappropriate revenue recognition

A key and often complex accounting issue within accounting investigations is inappropriate revenue recognition, which remains a mainstay of financial reporting fraud. The risks of inappropriate revenue recognition are heightened in economic downturns when there are pressures to keep earnings high and to not breach banking covenants.

Incorrect revenue recognition can enhance both the profitability and assets of a corporation. Revenue is often a key performance indicator (KPI) for companies, with targets often announced to the market that foreshadow results.

Where financing, refinancing, or equity is being raised, the improper recognition of revenue can provide a misleading picture of the financial health of the company and induce investors into making incorrect decisions. Current and past revenue is also often used as a guide to future earnings.

Regulatory focus

Improper revenue recognition schemes are a focus of enforcement agencies around the world. Regulators, including the Financial Conduct Authority (FCA) in the UK and US Securities and Exchange Commission, are quick to assess practices that result in premature or overstated recognition of revenue in companies.

When revenue recognition issues are identified, this may lead to prior year restatements. We often see that current period misreporting builds upon behaviours that senior management got away with in previous periods, potentially to a less egregious extent.

Transgressions may start small, used to rectify a short-term gap, and potentially with the expectation that future growth will help hide subsequent reversals. This can be compounded by the company’s auditors not identifying issues at the time and providing the wrongdoers with the courage to repeat their actions.

Interpreting the guidelines

A company needs to meet all requirements of revenue recognition per accounting standards, for instance the risk and rewards being fully transferred, and with the substance of a transaction as a whole assessed as conforming.

Depending on the nature of the company and the services it delivers, revenue recognition can be subject to significant accounting estimates and judgment calls.

Inappropriate revenue recognition and earnings management typically brings forward revenues and profits, effectively ‘pulling forward’ future sales into current periods. There is a fine line between acceptable activities to increase sales at period ends, such as offering an additional discount, and activities that result in transactions that do not conform to the revenue recognition standards, eg, making an additional sale with an undisclosed right to return product if it is not later resold.

As business declines in challenging market conditions, we have seen improper activity exposed as the sales and profits in the current year are not available to mask prior year misconduct.

It is worth noting that revenue recognition may not be in clear breach of accounting standards and principles, such as in the example of ‘pulling forward’ future sales into current periods. However, a company could fail to disclose material information about their revenue management practices and therefore regulators could argue this rendered statements misleading.

If a company requested that customers accept shipment of certain products in the current month that they had ordered for delivery in future months, disclosure may be needed to investors of these practices, the incentives given to achieve the results, and the potential impact the pulling forward of the sales would have on future periods.

Focus on culture

Revenue recognition issues commonly stem from corporate culture, with an aggressive sales culture and poor tone-at-the-top, leading to pressure to over-recognise and/or a veneer of acceptance within organisations for improper practices.

Driving the inappropriate culture may be personal motivations for individuals to perpetrate misconduct, such as promotion, bonuses, sales commission, stock options and incentive plans, and even potentially the veneration of certain personality traits within sales teams.

Identifying the facts and impact

If there are allegations of improper revenue recognition that require investigation, to which a regulator - and eventually a court - may hold the company to account, companies and their counsel are likely to need to engage robust and independent accounting expertise.

A ubiquitous component of investigations is the preservation, collection, processing and review of evidence, the vast majority of which is in electronic form. For revenue recognition schemes, evidence requiring collection and expert analysis may comprise of:

- accounting records and data, including sales data, cash receipts, accounts receivable data, customer write-offs, warehouse receipts and sales order documents, which require bespoke investigative techniques and analysis;
- communication data, including emails and instant messages, with careful consideration needed to balance the amount of information captured and the time and cost of collection, while avoiding recollections; and
- interviews, starting with information gathering from those most knowledgeable of individual transactions, leading to (and in preparation for) formal interviews of senior protagonists.

Ultimately, seeking professional support is crucial when a complex revenue recognition investigation is required. Beyond conducting the investigation, advisors can help resolve matters such as the remediation of compliance and internal control gaps, and presenting the results of forensic procedures to regulators.

About the authors

Neil Keenan and Trevor Wiles, partners, and Ben Walter, associate director at Forensic Risk Alliance

Neil Keenan | Partner, Forensic Risk Alliance

Neil Keenan is a partner at Forensic Risk Alliance and co-lead of the firm's invest...

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