MarketWatch

How to spot some of the oldest revenue-cooking tricks

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Know the signs that a company may be seasoning its earnings

SAN FRANCISCO (MarketWatch) — Talk about a caffeine jolt. When securities regulators questioned whether Green Mountain Coffee Roasters had improperly booked sales, investors unceremoniously dumped the stock down the drain.

The high-flying shares lost 20% of their value within a week following the late September news of the Securities and Exchange Commission probe. The selloff shaved $1 billion from the market value of the fast-growing coffee company that sells the Keurig single-cup coffee machines and the coffee brewed in them.

Green Mountain GMCR hasn't been charged with any wrongdoing, but the stock hasn't yet recovered from the beating.

How a company accounts for sales can be a gray area of a financial statement, challenging an investor's ongoing efforts to give a company's earnings a thorough examination.

Accordingly, it's crucial to watch for any changes to the "revenue recognition" policy a company uses. This policy can be found in the "critical accounting policies" section of a company's 10-K and 10-Q filings with the SEC.

"Investors should use simple common sense," said Bill Whiteside of Behind The Numbers, a research firm that scrutinizes balance sheets for aggressive accounting.

Ask yourself: Does the revenue recognition policy make economic sense? Does it seem that the company is booking revenue unrealistically or too quickly? Moreover, is it possibly booking revenue that it may never collect?

Games companies play

Playing games with revenue recognition has tripped up scores of companies and their shareholders over the years. Some high-profile instances of the past two decades include heavyweights General Electric GE, -1.93% , AOL AOL (before the Time Warner merger), Xerox XRX, +1.54% and Lucent Technologies ALU, +1.45% .

The SEC charged all of them with aggressive accounting that boosted revenue or earnings. Read related story on how short-sellers spot corporate accounting gimmicks.

In Green Mountain's case, the SEC's investigation may go nowhere.

Green Mountain claims it hasn't changed its revenue recognition policy, which had been described in one sentence but now takes up three paragraphs in the company's 10-K filing.

A company spokeswoman says the policy's wording has grown to better tell investors how the company accounts for sales. Nonetheless, Green Mountain has made three minor changes in one year, something that isn't common.

For instance, Green Mountain modified its policy to indicate sales could be booked "in some cases upon product shipment." In theory, this switch could allow a company to report a sale sooner.

In prior reports, the company booked sales "upon product delivery."

It’s this type of nuance that balance-sheet sleuths look for when trying to determine if a company might be padding sales for any given quarter.

Besides checking on revenue recognition, there are other clues that a company is possibly manipulating sales:

Compare policies

When looking at one company, check on another that makes or sells similar products. The key is to see which company within an industry sector appears to be more aggressive in recording sales.

This is because all companies will phrase their revenue recognition policy so “it sounds right,” said Tom Robinson, managing director for education at the CFA Institute, a global association of investment professionals.

“The earlier in the process they book a sale, the less conservative they are,” Robinson said.

Days sales outstanding

It’s also important to check if a company is getting looser with its credit terms or offering other incentives to push more product onto its retailers.

To find out, calculate the days sales outstanding. This measures how fast a company is collecting revenue after a sale has been marked on the books. It can be done by matching the just-ended quarter with the same period a year earlier.

To calculate days sales outstanding on a quarterly basis, multiply total receivables by 91.25 days. Then divide that result by sales for the current quarter.

If the resulting number is two to three days higher than the previous year’s quarter, this could be a clue that a company is getting more aggressive, said Whiteside of Behind The Numbers.

Yet be aware that a higher days sales outstanding number does not always prove accounting shenanigans.

For instance, days sales outstanding can increase if a company made an acquisition or is experiencing accelerated sales growth. So further fact-digging is required before drawing any conclusions, he said.

All things equal, days sales outstanding should be stable.

One company where days sales outstanding are on the rise is Concur Technologies, a maker of human resources software that companies can use for travel expense reports and vendor payments.

This is one to watch since Concur Technologies CNQR issued a weak sales forecast for the third quarter, according to Behind The Numbers.

For the June 2010 quarter, the company’s days sales outstanding were six days higher than the prior year’s period. For the March quarter, they had jumped by seven days, Behind The Numbers points out.

Deferred revenue

Deferred revenue is another place to check for sales discrepancies on a company’s books. It can be found on the balance sheet under the liabilities section.

It is an important item. Deferred revenue is money collected before a company ships its product. It is considered a liability until the revenue is recognized on the income statement. Software companies often accumulate deferred revenue.

A company can spread that upfront payment over the length of the contract tied to particular product, which could be several quarters.

Or, it can opt to book more of that revenue sooner rather than later.

Normally, you want to see deferred revenue and sales growing at roughly the same pace.

Here's what to watch out for: If the amount of deferred revenue being reported each quarter is growing at a slower rate than sales growth, this may be a sign a company is closing fewer deals and future revenue will wane.

It also "could be an indication management is getting more aggressive in recognizing revenue up front," Whiteside said.

Either way, this could affect a company's future profit, and perhaps, its stock price.

Unbilled receivables

Look out for a sharp jump in unbilled receivables, which are listed in the current assets section of the financial statements.

These are long term contracts under which a company agrees to perform certain work over a length of time and periodically bills the customer for completed work.

Here's the catch: Under U.S. accounting rules, it is possible for a company to report the sale on its financial statement before it is even paid for the work.

First Solar Inc. FSLR, +2.08% has caught the eye of Behind The Numbers here. During the first quarter, the solar panel maker reported $26 million in unbilled receivables, a line item it had not done in the past.

Behind The Numbers suspects this extra money helped First Solar top Wall Street's sales target for the period. By the end of the second quarter, the company reported $105 million in unbilled receivables.

First Solar said July 29 it expects to collect those payments in the next 12 months. Investors could find out what, if anything, has been collected when First Solar reports earnings Oct. 28.

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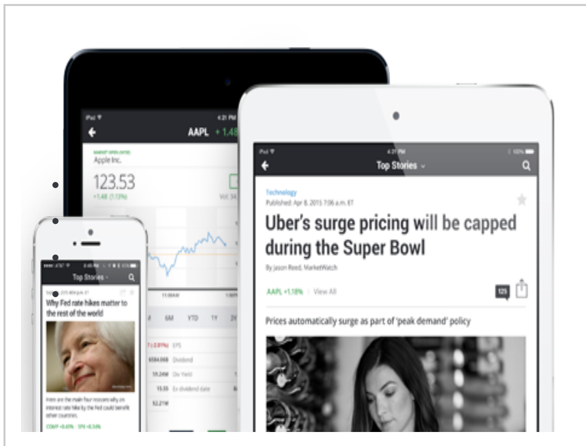

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