PacificCPE

COURSE
21803A

Defining Profit and Revenue Recognition Principles

Profit sounds straightforward—until you look closely. This course challenges you to think critically about what profit really means and how revenue recognition rules shape the numbers companies report. You'll examine the principles behind recognizing revenue, common pitfalls, and how judgment calls can dramatically affect financial results. Whether you work in audit, tax, or advisory, understanding these concepts helps you ask better questions and provide more informed guidance to clients and stakeholders.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the costs that should be deducted when calculating bona fide profits.
- Recall the characteristics of Bristol-Myers Squibb's financial reporting gimmicks.

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Chapter 1: WHAT IS PROFIT?

Chapter Objective

After completing this chapter, you should be able to:

- Identify the costs that should be deducted when calculating bona fide profits.

Profits hold an exalted place in the business world and in economic theory. The necessity of producing profits imposes order and discipline on business organizations. It fosters cost-reducing innovations, which in turn promote the efficient use of scarce resources. The profit motive also encourages savings and risk taking, two indispensable elements of economic development. Finally, profitability is a yardstick by which businesspeople can measure their achievements and justify their claims to compensation.

In view of all these essential economic functions, one might suppose that users of financial statements would have long since devised a universally agreed-upon definition of profit. This is the case, however, only at the following, extremely rudimentary level:

Profit = Revenue - Costs

Defining profit in such a manner merely stirs up questions, however: What is revenue? Which costs count? Or, more precisely, which costs count now, and which count later? Because these questions can be answered in many different ways, countless definitions of profit are in common use. For analysts of financial statements, the most important distinction to understand is between bona fide profits and accounting profits.

BONA FIDE PROFITS VERSUS ACCOUNTING PROFITS

In defining bona fide profits, the simple formula, revenue minus costs, represents a useful starting point. When calculating this kind of profit, the analyst must take care to consider only genuine revenues and to deduct all relevant costs. A nonexhaustive list of costs includes labor, materials, occupancy, services purchased, depreciation of equipment, and taxes. No matter how meticulously the analyst carries out these computations, however, no calculation of profit can be satisfactory unless it passes a litmus test:

After a company earns a bona fide profit, its owners are wealthier than they were beforehand.

To underscore the point, there can be no bona fide profit without an increase in wealth. Bona fide profits are the only kind of profits that truly matter in financial analysis.

As for accounting profits, generally accepted accounting principles (GAAP) define voluminous rules for calculating them with extraordinary precision. For financial analysts, however, the practical definition of an accounting profit is simple:

> *An accounting profit is whatever the accounting rules say it is.*

If, during a stated interval, a business adds nothing to its owners' wealth, but the accounting rules state that it has earned a profit, that is good enough. An accounting profit that reflects no genuine increase in wealth is certainly sufficient for many stock market investors. They cheerfully assign a price-earnings multiple to any number that a reputable accounting firm waves its magic wand over and declares to be a profit.

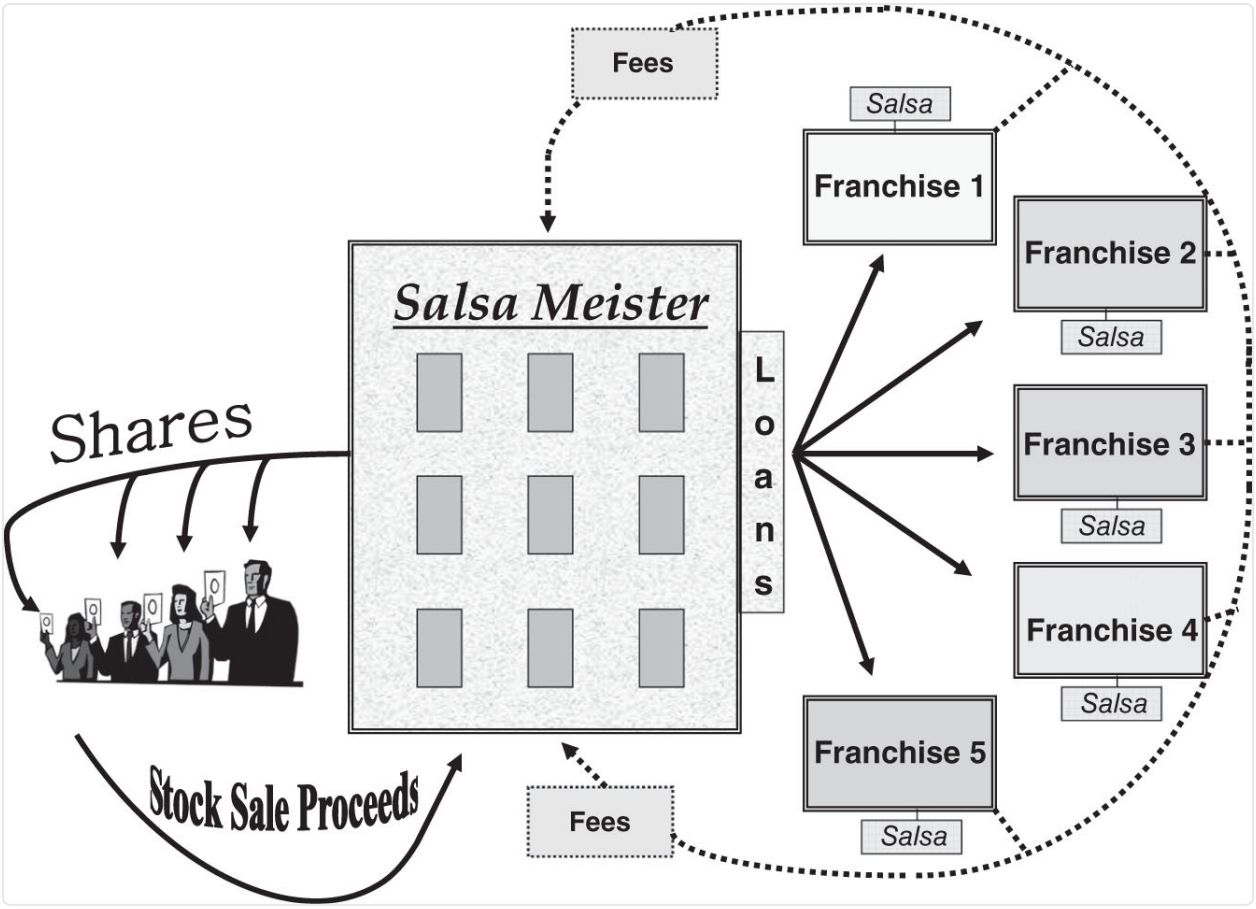
What Is Revenue?

Suppose, for example, that an entrepreneur launches a restaurant-franchising business. The fictitious Salsa Meister International does not operate any Salsa Meister restaurants. It merely sells franchises to other entrepreneurs and collects franchise fees.

The franchised restaurants, sad to say, consistently lose money. That fact has no bearing on Salsa Meister International's accounting profit, however. The restaurants' operations are not part of Salsa Meister International, their revenues are not its revenues, and their costs are not its costs. Salsa Meister International's income consists entirely of franchise fees, which it earns by rendering the franchisees such services as developing menus, providing accounting systems, training restaurant employees, and creating advertising campaigns.

An astute analyst will ask how money-losing franchisees come up with cash to pay fees. The diagram in Exhibit 5.1 answers this riddle. Salsa Meister International sells stock to the public and then lends the proceeds to the franchisees. The franchisees send the cash right back to Salsa Meister International under the rubric of fees. Salsa Meister International gratefully accepts the fees, which exceed the modest costs of running a corporate headquarters, and renames them revenue.

EXHIBIT 5.1 TURNING STOCK MARKET PROCEEDS INTO REVENUE.



According to GAAP, Salsa Meister International has earned a profit. Investors apply a price-earnings multiple to the accounting profit. On the strength of that valuation, the company goes forward with its next public stock offering. Once again, the proceeds finance the payment of fees by franchisees, whose numbers have meanwhile increased in connection with the Salsa Meister chain's expansion into new regions. Accounting profits rise, and the cycle of relabeling stock market proceeds, first as fees and finally as earnings, starts all over again.

The astute analyst is troubled, however. Cutting through the form of the transactions to the substance, it is clear that Salsa Meister International's wealth has not increased. Cash has simply traveled from the shareholders to the company, to the franchisees, and then back to the company, undergoing a few name changes along the way.

Merely circulating funds, it is clear, does not increase wealth. If Jack hands Jill a dollar, which she promptly hands right back to him, neither party is better off after the so-called transaction than before it. By definition, neither Jack nor Jill has earned a bona fide profit. Salsa Meister

International has not earned a bona fide profit either, regardless of what GAAP may say about accounting profits.

Sooner or later, investors will come to this realization. When that happens, the company will lose its ability to manufacture accounting profits by raising new funds in the stock market. Salsa Meister's stock price will then fall to its intrinsic value—zero. Investors will suffer heavy losses, which they could have avoided by asking whether the company's reported profits truly reflected increases in wealth. Moreover, the investors will continue making similar mistakes unless they begin to understand that bona fide profits sometimes differ radically from accounting profits.

WHICH COSTS COUNT?

The willingness to take accounting profits at something other than face value is an essential element of genuinely useful financial statement analysis. It is likewise imperative that analysts exercise care in deciding what to substitute for a GAAP definition of profit. Once they leave the GAAP world of agreed- upon rules, analysts enter a free market of ideas, where numerous parties hawk competing versions of earnings.

Corporations have vastly increased their promulgation of non-GAAP numbers in this century. By 2017, the independent research provider Audit Analytics found that fully 97 percent of S&P 500 companies included some self-produced measures in their earnings releases, up from a little over half two decades earlier. Between 1996 and 2016 the average number of non-GAAP items in those statements rose from just over two to more than seven[1].

Analysts need to be discriminating in their use of these alternative presentations of reality, but the same can be said of GAAP numbers. Economist Andrew Smithers found that in the ten-year periods ending 1957 to 2002, the reported earnings of the companies constituting the S&P 500 were about as volatile as the top-down corporate earnings drawn from U.S. national accounts. In subsequent years, Smithers found, the companies' reported earnings were five times more volatile than the after-tax profits reported in the national accounts[2].

Smithers deemed it highly unlikely that the national accounts data had become unreliable. The other explanation for his findings was that accounting reforms of the 1990s rendered GAAP earnings much more volatile than formerly. Shifting numerous items from **historical cost** accounting to **fair value** accounting was meant to promote more efficient allocation of capital. The unintended effect was to make reported earnings more procyclical, as asset prices incorporated estimates of future profits as well as currently realized earnings. This was one reason reported earnings became less closely correlated with movements in stock prices. Analysts who deployed their skills within investment organizations had little choice but to pay greater attention to companies' non-GAAP figures, notwithstanding the underlying calculations' lack of standardization.

Many of the deviations from GAAP hang on the question of which costs to eliminate from the calculations. While some of the popular income statement variants offer insight into knotty problems of financial statement analysis, others have the opposite effect of obscuring the facts. Many issuers of financial statements attempt to exploit dissatisfaction with GAAP by encouraging analysts to adopt earnings measures that make their own profits appear higher than either their accounting profits or their bona fide profits.

In 2020, some companies broke new ground by adding back costs imposed by the COVID-19 pandemic. German manufacturer Schenck Process turned a 16 percent year-over-year earnings decline in that year's first quarter into an increase of nearly 20 percent by steering analysts toward its EBITDAC, i.e., earnings before interest, tax, depreciation, amortization, and coronavirus[3].

Not surprisingly, corporations' stepped-up use of non-GAAP has attracted regulators' attention. The Securities and Exchange Commission's Regulation G does not prohibit companies from presenting non- standard numbers in their earnings releases. In those releases, however, companies are required to explain why they are providing a non-GAAP metric and quantitatively reconcile it with the most directly comparable GAAP metric. Companies must also present the comparable GAAP metric at least as prominently as the non-GAAP one.

The archetype for many alternative earnings measures is a version that adds back depreciation. As far back as 1930, one investment expert urged investors to ignore accounting-based earnings in the following words:

> *Textbooks will advise the investor to look for earnings figures which give effect to depreciation charges. But depreciation, after all, is a purely accounting item, and can be adjusted, within limits, to show such net earnings as are desired. Therefore it would seem preferable for the investor to obtain, if possible, earnings before depreciation, and to make his own estimate of depreciation in arriving at approximate net earnings*[4].

Observe that the author does not dispute the relevance of depreciation to the calculation of earnings[5]. Rather, he objects that it is too malleable. The issuer of the statements can raise or lower its reported earnings simply by using its latitude to assume shorter or longer average lives for its depreciable assets.

It is fair to assume, in the case of financial statements that companies present to potential investors, that "such net earnings as are desired" are higher than the company's bona fide profits. Therefore, the necessary adjustment is to *increase* depreciation and thereby *reduce* earnings. The author agrees with today's boosters of alternative earnings measures that proper analysis requires adjustments to reported income, but he is very far from urging analysts to ignore depreciation altogether.

Promoters of many companies with negligible reported earnings, on the other hand, are not bashful about urging investors to disregard depreciation. This audacious assault on the very foundations of

accrual accounting draws its inspiration from the world of privately owned real estate, where the logic of managing a public company is turned upside down. Instead of exploiting every bit of latitude in the accounting rules to maximize reported earnings, private owners of real estate strive to minimize reported income and, by extension, income taxes. Accordingly, when a private investor acquires a building (a depreciable), the investor typically attributes a large portion and the land that it sits on (which is not depreciable), they typically attribute as large a portion of the purchase price as possible to the building. That treatment maximizes the depreciation expense and minimizes the owner's taxes.

Let us suppose that annual rental revenue on the building offsets the landlord's out-of-pocket expenses, such as maintenance, repairs, property taxes, and interest on the property's mortgage. The owner, in other words, is breaking even, before taking into account the noncash expense of depreciation. Including depreciation, the property shows an annual loss, which reduces the owner's income tax bill. Let us also assume that after a few years, the owner sells the land and building. After paying of the mortgage balance, the owner walks away with more cash than originally invested, thanks to the tendency of real estate values to rise over time.

Recapping, the real estate investor has sold the property for more than was paid. Their gain has not been reduced along the way by net cash outlays on operations. The investor's gain has not been reduced along the way by net cash outlays on operations. On the contrary. . . the rise in the investor's wealth. The key point is that the investor is wealthier now than prior to purchasing the building. According to our definition, the investor has realized a bona fide profit, despite reporting losses every single year. Adding to the paradox is the investor's success in selling the property for a gain. Economic theory states that an investment has value only because it produces profits. By extension, the value can increase only if the profits increase. In this instance, however, the property's value rose despite an uninterrupted flow of red ink.

Naturally, these curious events have a rational explanation. The rate at which the tax code allows owners to write off property overstates actual wear and tear. Over the typically very long life of a building, it may get depreciated several times over for tax purposes. The disparity between economic depreciation and tax-based depreciation may be viewed as a subsidy for socially productive investment. Alternatively, it can be seen as a testament to the real estate operators' influence over the legislators who write the tax code.

Either way, a conventional income statement provides a cockeyed view of the profitability of buying and selling buildings. A closer approximation of reality ignores the depreciation expense altogether and focuses on **cash-on cash-profit**. In the simplest terms, the owners lay out a sum at the beginning of the investment and take out a bigger sum at the end, while also generating cash - through tax savings – during the period in which they own the building.

How Far Can the Concept Be Stretched?

To a limited extent, a profitability analysis that ignores depreciation is applicable outside the world of real estate. In the broadcasting business, companies typically record depreciation and amortization expense that far exceeds physical wear and tear on assets. For example, when a company buys a radio or television station, the price reflects a comparatively small component of plant and equipment. The larger portion of the station's value derives from its exclusive right to utilize part of the broadcasting spectrum, a scarce resource that tends to become more valuable over time. Much as in the real estate illustration, the broadcaster may show perennial losses after depreciation, yet realize a handsome profit when it finally sells the station. Instead of analyzing broadcasters on the basis of conventional net income, it is appropriate for analysts to focus on **broadcast cash flow**, usually defined as:

operating income + depreciation and amortization + corporate overhead

(A more meticulous calculation of broadcast cash flow deducts cash outlays for acquisition of new programming while adding back the amortization of the cost of previously acquired programming; both items can be found on the statement of cash flows.)

Clearly, the deliberate neglect of depreciation is an analytical option that should be used with discretion. In many industries, fixed assets consist mainly of machines or vehicles that really do diminish in value through use. The major risk of analytical error does not arise from the possibility that reported depreciation expense will substantially exceed economic depreciation, but the reverse.

Through a false analogy with real estate and broadcasting, any marginally unprofitable company in a capital-intensive business can declare itself to be in the black. The trick is simply to proclaim that analysts should no longer consider depreciation. Supposed earnings generated in such fashion qualify as neither accounting profits nor bona fide profits, however.

CONCLUSION

Despite the critical importance of measuring profit, businesspeople cannot produce a definition that is satisfactory in every situation. Even the simple formula of revenue minus costs founders on the malleability of accounting-based revenues and costs. As Chapter 2 of course 21801B, Chapter 1 of course 21801B of course 21804B demonstrate, these basic measures of corporate performance are far too subject to manipulation and distortion to be taken at face value. Also, our brief discussions of real estate and leveraged buyouts show that net earnings can be calculated in perfect accordance with GAAP yet bear little relation to an investor's rate of return.

In light of such observations, financial analysts must walk a fine line. On the one hand, they must not lose touch with economic reality by hewing to accounting orthodoxy. On the other hand, they must not accept the version of reality that seekers of cheap capital would like to foist on them.