Nortel: Revenue Recognition

Requirement A:

1. When does US GAAP permit revenue from a “bill and hold” transaction to be recognized?

ASC 605-10-S99-1 provides guidance on the timing of when revenue should be recognized on certain “bill and hold” transactions. Revenue is recognized prior to delivery of the goods only if certain stringent criteria are met, including: (i) risk of ownership must have passed to the buyer; (ii) the buyer must have made a fixed commitment to purchase the goods; (iii) the buyer (not the seller) must request the transaction be on a bill and hold basis and must have a substantial business purpose for ordering the goods on a bill and hold basis; (iv) there must be a fixed schedule for delivery of the goods; (v) the seller must not have retained any specific performance obligations such that the earnings process is not complete; (vi) the ordered goods must be segregated from the seller’s inventory and not used to fill other orders; and (vii) the goods must be complete and ready for shipment. The above listed conditions are the important conceptual criteria that should be used in evaluating any purported bill and hold sale. This listing is not intended as a checklist. In some circumstances, a transaction may meet all factors listed above but not meet the requirements for revenue recognition. The Commission also has noted that in applying the above criteria to a purported bill and hold sale, the individuals responsible for the preparation and filing of financial statements also should consider the following factors:

1. The date by which the seller expects payment and whether the seller has modified its normal billing and credit terms for this buyer

2. The seller’s past experiences with and pattern of bill and hold transactions

3. Whether the buyer has the expected risk of loss in the event of a decline in the market value of goods

4. Whether the seller’s custodial risks are insurable and insured

5. Whether extended procedures are necessary in order to assure that there are no exceptions to the buyer’s commitment to accept and pay for the goods sold (i.e., that the business reasons for the bill and hold have not introduced a contingency to the buyer’s commitment). Delivery is generally
not considered to have occurred unless the product has been delivered to the customer’s place of business or another site specified by the customer. If the customer specifies an intermediate site but a substantial portion of the sales price is not payable until delivery is made to a final site, then revenue should not be recognized until final delivery has occurred.

2. **How does IFRS compare with U.S. GAAP on the issue of “bill and hold” transactions?**

Under both IFRS and US GAAP, revenue is not recognized until it is both realized (realizable) and earned. With specific reference to IFRS, the bulk of the accounting guidance on revenue recognition is found in IAS 18 and IAS 11. Under US GAAP, there is a large volume of guidance on revenue recognition, including numerous industry standards.

Both US GAAP and IFRS have guidance that must be evaluated before a “bill and hold” transaction can be recorded in revenue. Specifically, IFRS guidance includes a requirement that usual payment terms apply to the transaction when the buyer takes title for revenue to be recognized, which is not mentioned in US GAAP. However, US GAAP requires a fixed delivery schedule and seller cannot retain any performance obligations. These requirements are not specifically included in IFRS guidance.

3. **Answer Nortel’s questions: (i) “Under what circumstances can revenue be recognized on product (merchandise) that has not been shipped to the end customer?” and (ii) whether merchandise accounting can be used to recognize revenues “when installation is imminent” or “when installation is considered to be a minor portion of the contract”?**

**i.** Generally the revenue will not be recognized until the criteria for recognition of revenue has been met. The conditions stated in solution #1 serve as important conceptual criteria that should be used in evaluating any bill and hold sale.

However, in some circumstances, a transaction may meet all factors listed but not meet the requirements for revenue recognition. In that light, the individual responsible for the preparation and filing of financial statements should also consider the following factors:

1- The date by which the seller expects payment.

2- The seller’s past experience with and pattern of bill and hold transactions.
3- Whether the buyer has the expected risk of loss in the event of a decline in the market value of goods,
4- Whether the seller’s custodial risks are insurable or insured,
5- Whether the business reasons for the bill and hold have not introduced a contingency to the buyers’ commitment.

It is also possible for the customer to specify an intermediate site but a substantial portion of the sales price must be paid for revenue to be recognized on this product not shipped to the final site.

ii. As clearly stated by the SEC, “Assuming all other recognition criteria are met, revenue for the unit of accounting may be recognized in its entirety if the seller’s remaining obligation is inconsequential or perfunctory.

4. If you were the controller of Nortel, how could you have prevented the problem from arising?

In 1999 the SEC provided accounting guidance that laid out the several requirements for using bill and hold techniques. Although the listing is not intended to be a “checklist”, it serves as an important conceptual criterion for evaluating any purported bill and hold sale. The controller of Nortel, should have used this criteria to document their decision on using certain types of bill and hold transactions.

Additional Question: Summarize other revenue recognition practices governed by the codification of the SEC’s staff accounting bulletins for a public company.

This question should lead students to discover ASC 605-10-S99-1 (SAB 13.A.3 Delivery and Performance), if they have not yet found it.

Some specific practices refer to customer acceptance, inconsequential or perfunctory performance obligations, license fee revenue, layaway sales arrangements, nonrefundable up-front fees, and deliverables within an arrangement.

Requirement B:

5. When does U.S. GAAP recognize revenue from sales to a pass-through entity?

Pass-through entities are held to the same GAAP as the parent company. Under SAB 101 issued
in the year 1999, the SEC established the four main criteria for proper revenue recognition; (1) evidence that an arrangement between buyer and seller exists, (2) delivery of a product or rendering of a service, (3) a set or determinable price, and (4) an assurance that payment can be collected.

These criteria are straight-forward, however, companies get in trouble when several different pass-through entities exist with similar types of products or services but different revenue recognition methods.

6. **How does IFRS compare with U.S. GAAP on this issue?**

   The two primary differences are contained in the first two criteria, (1) evidence that an arrangement exists and (2) Occurrence of delivery. US GAAP contains criteria regarding the evidence of arrangement and IFRS does not have current language to include this component. With regards to delivery, under IFRS, it might be possible to demonstrate transfer of risk and reward without delivery.

7. **Summarize how Nortel justified recognizing its revenue on sales to a pass-through entity**

   The case does not say. Perhaps the best speculation is that justification was missing and the accountants responded to pressure to meet financial targets.

8. **Were Nortel’s revenue recognition manipulations successful?**

   In the short-term, Nortel was able to effectively manipulate its financial records and produce statements that displayed efficiency and financial responsibility. However, ultimately their unscrupulous acts and deviant behavior cost a remarkable company in the industry, its life.

   In a 2009 Wall Street Journal article, it reports that the Company filed for Chapter 11 bankruptcy protection in Delaware. Nortel owes companies more than $3.8 billion, according to court filings.

9. **What strategic decisions were made in this case?**

   Ultimately Nortel elected to settle with the SEC and admit to its inappropriate accounting behavior. During this time it lost market capitalization of $398 billion in September 2000 to less than $5 billion in August 2002.

   Nortel fired CEO John Roth and restated approximately $900 million of liabilities it carried on its
balance sheet of June 30, 2003. They scrambled to get a credit support facility of up to $750 million from Export Development Canada (“EDC”).

The strategic decisions that were made by Nortel and its management were ones of reactive rather than proactive. Poor unethical decisions made in the past for short-term accomplishments ultimately led down a slippery slope to ultimate ruin.

10. When does the culture of a company change its accounting practices?

Accounting practices are often referred to as the structure of the firm’s accounting policies. The culture can be deemed as human agency. Over time as these components interact, and the social processes of the accounting organization evolve they slowly change to “formal practices” within the accounting culture.

Important in this process are certain human factors that enhance or detract from the organizational culture that is interwoven in the accounting practices. A culture of the company that nurtures individuals toward wholeness will produce characteristics in the accounting and financial reporting practices that will include integrity, accountability, responsibility, commitment and diligence.