SEC Comment Letters: Revenue Recognition

Thesis Proposal, Business Honors Program
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Introduction

I. Problem Statement

The accounting profession is dependent in the US on the Financial Accounting Standards Board (FASB) to produce and uphold relevant standards for guidance to produce financial statements. A significant element of financial reporting is revenue recognition. The current pronouncements governing revenue recognition are outdated and disparate. FASB and IASB (International Accounting Standards Board) are working together to produce a current, general guidance for Revenue Recognition. Requests to provide additional or revised disclosures with respect to revenues are common subject of SEC comment letters, and yet there is an extreme lack of timeliness in improving standards.

II. Research Objectives

The purpose of this thesis is to explore factors contributing to the need for a new standard for revenue recognition. A related issue is to examine factors explaining delays in adopting a new standard given the problems posed by revenue recognition for SEC filings. A final objective of the research is to provide an understanding regarding how the new standard will make revenue recognition clearer and increase compliance. The research objectives will be accomplished by examining a sample of SEC comment letters collected from a specific year. SEC comment letters focused on revenue recognition will be identified from the broader sample and reviewed, looking for commonalities within the comments made relating to areas of issue to the SEC or type of revenue recognition. The history of the joint FASB and IASB project on revenue recognition will also be studied and summarized.
Review of Literature

An earlier study examined a sample of 261 companies who disclosed at least one material weakness in internal control in their SEC filings after the Sarbanes-Oxley Act of 2002. One of the main causes of the material weaknesses was deficient revenue recognition policies. The authors state that the process of finding and correcting revenue recognition errors is timely and costly. The cost is not only of monetary value, but can also cost a corporation its reputation and confidence from its shareholders (Ge, McVay, 2005).

Beginning in May 2005, the SEC started a new practice of publicly releasing comment letters. Disclosure filings with the SEC are subject to staff review and a comment letter may be issued following a review if the staff has questions or concerns or believes the filing is incomplete or could be improved. After companies receive a comment letter from the SEC they have 10 business days to respond. If the SEC is unsatisfied by the response or the company fails to respond within 10 days, the SEC will send a follow-up comment letter until the error has been remedied (Davidson, Raghunandan, Wreiden, 2009). In a previous study, 60 comment letters related to Internal Control disclosures issued by the SEC in 2008 were reviewed. The information provided by this sample of comment letters indicated insight into areas of interest to the SEC (Davidson, Raghunandan, Wreiden, 2009). This current thesis project will conduct a similar review of letters related to revenue recognition.
The amount of comment letters from the SEC on revenue recognition error and Internal Control disclosures raises interesting questions. Has the SEC become stricter in acceptance of revenue recognition or has following the current standards become significantly difficult for corporations?

The FASB and IASB projects concerning revenue recognition have been ongoing since 2002 and a final standard is expected to be issued in 2014. There are four main objectives of the proposed Revenue Recognition standard: (1) to remove inconsistencies and weaknesses in existing revenue recognition standards and practices. (2) to provide a more robust framework for addressing revenue recognition issues. (3) to improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets and (4) to simplify the preparation of financial statements by reducing the number of requirements to which entities must refer (Holzmann, Rhamnath, 2013). The proposed standard will also provide a new definition for revenue recognition: “inflows or other enhancements of assets of the entity or settlements of its liabilities or a combination from delivering or producing goods, rendering services or other activities that constitutes the entity’s ongoing or major central operations (Holzmann, Rhamnath, 2013).” It will adopt a “contract-based model” that will measure a company’s net position in any contract as its contracts rights minus its contract obligations, and then would recognize revenue when that net contract position changes over the life of a contract. This new model is still consistent with the conceptual framework of revenue equals changes in assets and liabilities (Holzmann, Rhamnath, 2013).
The most recent Exposure Draft was in November 2011, *Revenue from Contracts with Customers*. In 2012, the Board published *Revenue from Contracts-Proposed Amendments* that was open for public comments until March 2013. The Board has stated that the implementation of a new standard is still sometime away, with the earliest effective date January 1, 2015. The Board has hosted webcasts, conferences, and public roundtables in order to receive the widest feedback possible. This feedback will allow the Board to determine if proposals are clear and may be applied so that it can communicate the economic substance of a transaction, identify any unintended consequences, ensure the staff is aware of any significant changes to current practice, and educate constituents about the proposals and basis for the Board's conclusions (Project Update, 2014).

**Methodology**

The research design is to study archival data. This project will identify a sample of 100 companies that received a comment letter from the SEC within a recent specified year using the tool Morningstar Document Research 10K Wizard. The comment letters will be analyzed to determine how many involved requests concerning revenue recognition and what types of revenue recognition issues were most common? The letters and resulting correspondence between the SEC and the company will be reviewed to determine how the issues raised were resolved and whether the remedy involved additional disclosures or revisions. The companies receiving comment letters will then be categorized according to industry and measures of size (total revenues and total assets), based on data collected from Compustat. This information will be used to
further explore the necessity of improved revenue recognition guidance for particular industries or based on firm size.

After assessing the importance and gravity of revenue recognition reporting issues, the research will analyze the reasons behind FASB’s and IASB’s lack of timeliness for a new standard by consulting articles published by FASB and IASB related to the joint-project beginning in 2002. As well as, exploring the subsections of the new standard to test if it is addressing the industry-specific issues found using the Morningstar Document Research 10K Wizard tool by analyzing the subsections posted by FASB. Lastly, the thesis research will gather public commentary from the accounting profession, specific industries, or other constituents being affected by the new standard to analyze the overall acceptance, rejection, or concerns by each.

**Implications and Limitations**

As part of the thesis, I will conduct research in order to identify and analyze major reporting issues in the revenue recognition area. An important question focuses on whether there is direct noncompliance, lack of clarity on reporting standards or differences of interpretation and opinion.

By conducting a sample-based research method, a limitation that arises is the applicability of the findings to represent the whole. The conclusions need to be carefully examined and tested to ensure a faithful representation.
Appendices

Timeline:

May 31, 2014 – All data will be collected, analyzed, and categorized from 10K Wizard and Compustat.

June 30, 2014 – Data of FASB’s timeline and subsections of the new standard will be collected and analyzed.

August 29, 2014 – Rough Draft submitted to Dr. Mynatt for review.

September 30, 2014 – Revised rough draft submitted to Dr. Mynatt for review.

November 2, 2014 – Final draft submitted to Dr. Mynatt.

December 2014 – Thesis submitted to the University Honors Program for final approval.
References


Holzmann, O. J., & Ramnath, S. (2013). An Update on FASB’s and IASB’s Joint Revenue Recognition Project. *Wiley Periodicals, 10*. Retrieved March 24, 2014, from https://pod51030.outlook.com/owa/service.svc/s/GetFileAttachment?id=AAMkAGU2MDDE0MmMzLTZkMTktNGJlMS1hZmEyLTUwNTg0NjA4YTg0MQBGAAAAA5AB5zs

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