Accounting for revenue uncertainty

The past 20 years have seen an increasing focus on mark-to-market accounting when determining corporate profits. This has been accompanied by a dramatic growth in contracts where multiple complex contingencies interact to affect valuation. David Rowe argues that a recent proposal to partition revenue into three components would bring added transparency to financial statements

The traditional accounting rules – generally accepted accounting principles and international accounting standards – were developed in a very different era. They have always endeavoured to meet the need for judgements that affect earnings, many of which relate to uncertain events in both the near and distant future. But the breadth of these judgements' applicability and their leverage over reported profit and loss were modest.

Also, the issues involved and the nature of the judgements made were reasonably easy to document in notes to the financial statements. In this context revenue was, and is, reported as a single aggregate figure, perhaps distinguished by line of business but not segmented by the nature of judgements entering into its determination.

Mark-to-market accounting has always been applied to certain types of business entities, especially broker-dealers and others whose main activity involves two-way trading in active markets. One change in the past 20 years has been the growing range of businesses utilising contracts with contingent claims, such as futures, swaps and options. Parallel with this we have seen the rise of contracts in which multiple complex contingencies, often far in the future, interact to affect valuation. In the face of these changes, accountants have doggedly stuck to the traditional concept of a single undifferentiated revenue number. Now seems like an appropriate time to question the continued applicability of this approach.

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Realised and unrealised events

Gordon Goodman, a member of the FASB Energy Trading Working Group, recently argued for maintaining a clear accounting distinction between realised revenue arising from past events and realisable (but as yet unrealised) revenue arising from uncertain future events.[1] He also argues for a further distinction between realisable earnings from activities in liquid markets and those from activities in illiquid markets. Goodman believes investors would place a premium on realised versus unrealised revenues, and would discount unrealised revenues from illiquid markets especially heavily.[2] He points out that the Securities and Exchange Commission (SEC) acknowledged this issue in its Financial Reporting Release 61 related to fair value accounting of energy trading contracts. In this release, the SEC recommended that registrants disclose, in the management discussion and analysis, information about:

- the manner in which fair values were determined;
- the time period over which those values will be realised; and
- the nature of changes in fair values between periods.

Presumably, the rationale for these disclosures would be that investors would find this information relevant to equity valuation.

The need for mark-to-model

Mark-to-model valuation techniques are essential to the development of new and innovative financial instruments. Any new instrument is, by definition, not traded in an active market with two-way deal flow. In this initial stage, the typical approach is to use some form of model-based extrapolation rooted in current market data and past experience. The uncertainty surrounding such a valuation procedure is the basis for initially wide bid/offer spreads. Innovators expect these spreads to be realised eventually. Prior to being realised, they expect these spreads to be validated by visible quotes in increasingly liquid markets. In the meantime, the magnitude of the spread is the justification for accepting the valuation uncertainty.

When such mark-to-model revenue is a small share of the total revenue, there is little harm in this approach. The issue is different, however, when mark-to-model is the basis for a significant portion of either the level or the change in total reported revenue. Clearly such procedures involve significant judgemental inputs, and these judgements are not rendered in a vacuum. The temptation is very great to shade valuations in a favourable direction in the face of intense market pressure for sustained earnings growth.[3] I am convinced that this was a significant component in the collapse of Enron, which took great pride in being primarily active in creating new markets.

A reasonable reform

Accountants are currently forced to determine revenue recognition on an all-or-nothing basis. Once recognised in the financial statements, one unit of revenue is indistinguishable from another, regardless of the uncertainty surrounding its determination. I believe Goodman is correct that investors would find it useful for accountants to distinguish among the three classes of revenue he describes. In particular, such a regime would have highlighted the significant dependence of Enron's reported financial performance on the uncertain valuation of illiquid contracts. Perhaps this would not have altered investor perceptions in the *fin de siècle* stock market euphoria, but it would have provided valuable insights after the fact, and a healthy object lesson for the future. ■

[1] *Goodman G,* Differences in the quality of earnings: a proposal to improve financial statements, *Garp Risk Review, Nov/Dec 2003, pages 6–8*

[2] *Goodman actually goes further and argues that existing FASB guidance, if considered objectively, would prohibit recognition of most revenue arising from illiquid markets*

[3] *See Rowe D,* A buffeting for derivatives, *Risk April 2003, page 40*