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When revenue recognition is questionable

How to spot "channel stuffing"

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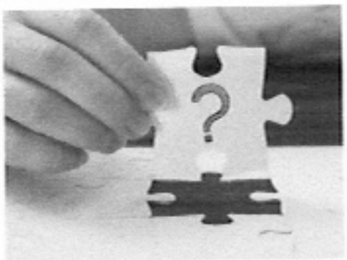

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The news is normally full of cases of questionable accounting, and several lately have dealt with questionable revenue recognition. The following examples reveal trends that can help advisors reduce portfolio risks.

Performance Sports Group (PSG), the owner of the Bauer and Easton brands, has been fielding inquiries from the OSC and SEC regarding its accounting. In January 2016, PSG surprised the market by reporting declining revenue and EBITDA and then, in March 2016, by reducing its EPS guidance for the year by more than 80%.

In August 2016, a U.S.-based law firm filed a complaint alleging the company misstated its revenue and profits by using an accounting practice known as channel stuffing. In the 12 months that ended in August 2016, PSG's stock was down 79%.

What's channel stuffing?

Channel stuffing comes in different forms, but generally involves pulling revenue forward into earlier periods when it should be recognize later. This allows a company to report higher sales and profits, and can skew investor perceptions about growth trends and share values.

PSG is alleged to have provided volume discount incentives for customers to take on more inventory than end markets demanded. When that happens, inventory builds up in the channels and might be either returned unsold or stockpiled, reducing the requirement for future normal shipments and leading to a sharp drop-off in sales.

Channel stuffing is generally not a successful accounting manipulation over the longer run because it is either quickly detected or requires increasingly larger cover-ups to be successful.

The manipulation of revenues can be particularly worrisome because the effect flows down the income statement, impacting several key metrics, before it reaches bottom-line net income.

Revenue timing issues

Hain Celestial Group, a natural food and personal products company known for brands like Terra Chips, Casbah, and Yves Veggie, saw its shares fall by one-third in August 2016 on news regarding its revenue recognition. Hain's board is currently investigating whether the concessions it granted to some distributors were accounted for correctly.

The company normally records revenue when it ships product to distributors, but is now looking at whether some of the sales should have been recognized when the goods were ultimately sold by the distributors to the end customers.

While the investigation is still underway, the eventual adjustment to sales might not be dramatic and might merely result in the normal sales cycle being pushed back. This seems more like a timing issue that would not fall into the traditional category of channel stuffing, which has more aggressive and negative connotations.

In an interesting parallel, Valeant Pharmaceuticals, which had already been suffering from major concerns at its business, restated its revenue in early 2016. However, as far as actual figures went, the adjustment was fairly muted. In March 2016, the company disclosed it would have to restate $58 million of sales on total 2014 revenue of $8.1 billion.

What's the difference?

It's quite often that the difference between channel stuffing and more benign accounting restatements comes down to whether past revenues are rescinded altogether or merely moved to another period. Also important is the materiality of the impact, or the proportion o revenues that were reported too early or inappropriately.

In Valeant's case, the amount in question was less than 1% of sales, and came after the share price had already plunged over 60% on the heel of numerous warnings about its non-GAAP reporting, balance sheet leverage, tax structure, drug pricing practices and executive compensation plan. The revenue reporting issue simply added questions about internal reporting control deficiencies and overall executiv tone when it came to the financial statements of the company.

Red flags to watch for

The market's reaction to many accounting issues, and revenue recognition issues specifically, is to sell first and ask questions later. This is because even a small shift in revenue can take on larger meaning if the difference allows the company to meet EPS guidance, for instance.

Likewise, it might nudge a key inflection point on the company's growth trajectory, which might be the basis for a high-multiple valuation In most cases, channel stuffing has short-lived benefits. Combined with the fact that accounting manipulations are often borne out of operational problems at the companies that employ them, it helps to look for signs of deteriorating fundamentals as a red flag.

In the case of PSG, the alleged channel stuffing might have been a reaction to softening customer markets, including the Chapter 11 filing o the Sports Authority chain in the U.S.—but nothing has been proven in this case.

As for a situation where the details are more established, the Serious Fraud Office of the U.K. charged executives in August 2016 for the accounting scandal at supermarket Tesco plc. In 2014, the office uncovered accounting irregularities, including the premature recognition of commercial income related to promotions. The push to show better results came at a time when Tesco was facing significant competition from foreign and domestic discount rivals.

In short, a significant warning sign to advisors is when a company continues to show results that seem unexpectedly resilient in the face of known pressures and market competition.