



The Case of Barter Transactions and Revenue Recognition

By Chris Baker

Matt, eCrawler's curmudgeonly chief financial officer wants this business to work with every bone in his body. Can he see his way through the company's planned IPO?

Abstract

eCrawler.com is entering the home stretch on the road to its initial public offering. Dreams are soon to be realized. Two significant deals are closing that, taken together, should drive eCrawler through a successful public financing. But upon closer review in light of recent Securities and Exchange Commission and Emerging Issues Task Force barter revenue interpretations, the two defining agreements may not afford recognition of the anticipated revenue. Without the momentum generated from this revenue, the entire IPO could sink. What should eCrawler.com do? Examine the facts and determine the course of action you believe should be taken.

Background

Matt Thurman was clearly frustrated as he prepared for his revenue update meeting with Ben Caliori, eCrawler.com's dynamic chief executive officer. Matt, eCrawler's curmudgeonly chief financial officer, wanted this business to work with every bone in his body. Matt had already invested two long years at eCrawler helping to take it from an idea to a real company. Matt had left a lucrative position with a respected financial consulting group to lead the financial and operations groups at eCrawler. Matt very much believed in the power of the Internet to reshape business and society. In particular, he had believed in eCrawler's vision and business plan. Now he wasn't so sure anymore. He was still very passionate about what eCrawler was trying to do. However, he was struggling to see his way through the company's planned IPO, which was less than two months away. As Matt reviewed the revenue numbers and two key contracts, he knew that some big decisions were in the making. He wasn't looking forward to his meeting with Ben.

eCrawler.com's business was to blanket the Web with custom-created specialized Internet search solutions. eCrawler was committed to delivering quality and highly relevant search results for business professionals. The frustrations that Web users experienced when querying the major Internet search portals provided the opportunity and niche for eCrawler. The Web sites and e-businesses that deployed eCrawler's tailored, private-labeled search engines paid eCrawler. eCrawler's customers were in turn rewarded with more and happier site visitors and Web customers.



The Problem

Matt and Ben met for lunch just outside their offices at a little San Francisco sandwich café catering to the South of Market dot-com crowd. “Ben,” Matt began, “to date our revenues are generally in line with our projections and the expectations we’ve set. But I’m concerned about recognizing revenue on the wamSports search portal deal and also on our deal with iPortola. Without that revenue we won’t scale as projected and confidence in our business will be shattered before our credibility can be built.”

Ben was clearly frustrated and immediately tore into Matt. “Didn’t we discuss revenue recognition as a management team and with our auditors before drafting those deals?! We knew we were slightly in the gray area, but as I remember we received a ‘thumbs up’ on both deals. Why now the cold feet? It is simply unthinkable not to record the revenues on those deals--we’ve worked too hard and invested too much.” It was true that revenue recognition for each deal had been discussed on more than one occasion and that the auditors were briefed before the deals were completed. However, everyone on the management team believed that Matt would perform his magic and left the revenue issues for him to resolve. The auditors were gun-shy from the beginning and hadn’t committed to any specific accounting treatment for the contracts. Ben had been briefed on the auditors’ noncommittal position, but sometimes he had a selective memory.

Matt was not prepared to let Ben off the hook. The company’s future was literally at stake. He replied calmly, “Ben, I know how far we’ve come. I also know many startups never get close enough to smell the success that we’ve already started to taste. We’ve been good and lucky along the way. And many times we’ve done what we’ve had to do to stay in the game. But now the stakes are higher--for me personally, for you and certainly for our accountants and the IPO investors who will rely on our financial statements. The SEC has been coming down hard on Internet companies reporting revenue from barter advertising deals. The rules are different for us than most other companies. We are developing a whole new economic landscape based on a new medium. Sometimes the rules may not seem to make sense, but that doesn’t change our fiduciary duty to follow them. We can’t lose sight of that and I’m sure in the end, our accountants won’t let us.”

While different in style and character, Matt and Ben respected one another immensely. Ben had vision and could motivate a company and its stakeholders (employees, managers, investors and board members) around that vision. They both knew the company needed them to work through tough issues together. Matt continued, “Let’s just once again review one of the deals and see if we can find our way out of this.”

wamSports produced Web portals for major sporting events, including the Olympic games, Super Bowl, World Series, NBA finals, NFL playoffs and Nascar. eCrawler had been selected as their exclusive search engine partner. “In that deal, we both know that to interface our product to all those different event databases will require no small investment in time and people on our part. We will also reach literally millions of people with our name and search services. And we know that we do search services better than anyone. The tricky part is that wamSports also knows that we are relatively unknown



compared to the larger search portals and therefore required us to pay them for the marketing services they were providing us through reaching their audience. We knew that the deal was still very smart for us, and that over time we would get better terms as users came to depend on our high-quality search services. But the SEC seems to be taking a very tough stance in its interpretation of Accounting Principles Board Opinion No. 29, *Accounting for Nonmonetary Transactions*. That appears to restrict our ability to recognize the revenues from wamSports. In effect, we might have to offset what we are paying them against what they are paying us, even though they are for very different things.

“To recognize revenue in a barter exchange,” he continued, “we must either determine the fair market value of the services we are providing or the fair market value of the services we are receiving as if cash were exchanged in the open market. If no value can reasonably be determined, then we have to use the carrying value of the asset we are giving up. The problem is that the SEC doesn’t easily accept the value of what we are receiving as justification to recognize revenues for our services when what we are receiving is advertising. And it will be no easier determining the fair market value of the services we are providing. The SEC wants us to show a ‘historical practice’ of receiving or paying cash for similar transactions. The current guidance on how to demonstrate a ‘historical practice’ is murky and still being developed. Also, given our company’s short history and evolution, showing any ‘historical practice’ will be difficult. I can’t think of a cash deal that we’ve done recently that would neatly fit the established criteria for being similar to the wamSports deal. In our favor is that we could probably get reasonably close by estimating the marketing value we are getting from wamSports using industry standards and attempting to look at similar deals wamSports has completed with other service providers. But that doesn’t technically meet the standards for ‘historical practice’ as they are currently being applied by the SEC. It doesn’t help that we are paying wamSports 30% more than they are paying us. Now of course, we want to record the full value of the wamSports revenue to show the continued revenue growth that we’ve projected and also to increase momentum for our IPO. I know it’s absolutely critical we recognize that revenue. I’m just not sure how to do it.”

Ben was growing impatient with Matt’s continued rambling. But he did understand that the accounting rules were changing and the very future of his company depended on navigating through this sea of revenue recognition. He also respected Matt’s opinions and concerns. However, he had a company to run and survival now was more important than perfect accounting

Ben interrupted Matt. “Listen, we simply have to recognize these revenues. They are legitimate revenues for us. We are doing tons of work in addition to leveraging our already developed search content platform. What about the matching principle? Match costs with revenues. You accurately said yourself that we have costs associated with these deals. I want to meet with our auditors as soon as you can set it up to discuss our alternatives here.”



Matt knew that Ben was right in so many ways, but in the end none of that mattered. The SEC could change the rules as it pleased. Matt knew the upcoming auditor meeting would be difficult, but he was also hopeful it would be valuable. Time was running out on making these revenue decisions.

Comments on “The Case of Barter Transactions and Revenue Recognition”

Dan Hugo, CPA, is Director of External Reporting for EBay Inc.

Ebay pioneered a Web-based community in which buyers and sellers are brought together. EBay also engages in the traditional auction business and in online payment processing.

“It appears unlikely that any significant amount of revenue could be recognized under the barter advertising arrangements.”

Most of the questions that Matt and Ben raised during lunch have already been addressed by the EITF, which reached a consensus in EITF 99-17, *Accounting for Advertising Barter Transactions*, establishing criteria for barter advertising transactions. Barter revenue can be recognized on advertising transactions only when an entity has a history of *receiving* cash (including marketable securities, or other considerations that are readily convertible to a known amount of cash) for *similar* advertising transactions. It is important to note that the company has to have a history of *receiving* cash for advertising surrendered. Accordingly, if a company only has a history of paying cash, it will not be allowed to recognize any revenue on these barter advertising transactions. The only way that advertising surrendered for cash can be considered "similar" to the advertising being surrendered in the barter transaction is if the advertising surrendered has been in the same media and within the same advertising vehicle (for example, same publication, Web site or broadcast channel) as the advertising in the barter transaction. In addition, the characteristics of the advertising surrendered for cash must be reasonably similar to that being surrendered in the barter transaction with respect to:

- a. Circulation, exposure or saturation within an intended market.
- b. Timing (time of day, day of week, daily, weekly, 24 hours a day/7 days a week, and season of the year).
- c. Prominence (page on Web site, section of periodical, location on page and size of advertisement).
- d. Demographics of readers, viewers or customers.
- e. Duration (length of time advertising will be displayed).

In addition, an entity can only consider cash receipts during the last six months as evidence that it receives cash for similar transactions. However, if economic circumstances have changed so that prior transactions don't represent current fair value



for the advertising surrendered, then a shorter, more representational period should be used.

A past cash transaction can only support the recognition of revenue on advertising barter transactions up to the dollar amount of the cash transaction. In other words, the total revenue to be recognized under barter advertising transactions can never exceed the amount of cash received for similar transactions during the last six-month period. Based on the facts and circumstances provided in the case study it would appear unlikely that any significant amount of revenue could be recognized under the barter advertising arrangements.

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Author’s note:

The commentary below represents my own personal views and observations.

In the start-up environment, it is very common for companies to exchange services for their mutual benefit. Accounting for these non-monetary exchanges, also known as barter transactions, has been cause for much discussion among finance and accounting professionals for many years. The governing principles are in Accounting Principles Board Opinion No. 29, *Accounting for Nonmonetary Transactions*, and Matt has articulated them well.

The troubling comment made in the case is this: “It doesn’t help that we (eCrawler) are paying wamSports 30% more than they are paying us.” The term “paying” here seems to mean the value attributed to the services being exchanged. Presumably, Matt calculated this by reference to eCrawler’s price list. For example, for \$100 worth of advertising from wamSports, eCrawler provides \$130 worth of services to wamSports.

It appears that eCrawler made a conscious decision to discount its services by 23% (\$30 discount divided by \$130 regular price). This, of course, presumes that the wamSports advertising is at a regular, or fair market, value. All of these aspects would have to be thoroughly analyzed before coming to a conclusion.

While I empathize with Ben’s initial reaction, I strongly advise that he thoroughly examine the negotiations with wamSports--including the “give and take” that led to the



arrangement in place. This retrospective view, along with Matt’s analysis of pricing from both parties, should provide a basis for eCrawler and its auditors to decide on the appropriate amount to recognize as revenue.

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“The chief financial officer must understand the long-term economics of the product line.”

Revenue recognition policies and practices must be constructed so that the economics of the business are reflected in the company financial statements. The case study highlights a number of issues to which financial officers need to be particularly attuned. When looking at a single contract, and the financial reporting treatment afforded to that agreement, focusing solely on a financing event is very short sighted to say the least.

In the case cited, the chief financial officer must understand the long-term economics of the product line, how the products are to be sold and how the customer is using them. He should also understand the product road map and the overall competitive dynamics of the market place. The second part of the evaluation is the market awareness of the company’s product, and its overall performance in real world conditions. Revenue recognition practices begin with the economics of the transaction and the nature of the product or service will often dictate best business practice. To start by focusing on revenue recognition will lead to maximizing short-term revenue with an unmeasurable long-term opportunity cost. This particular case study does not provide enough detail to answer many of the questions above, and given that the topic is accounting for barter transactions, they are likely beyond the scope of this case study. However, this is the single most important decision that is being made. Best practices always start with an emphasis on long-term economics.

In terms of barter transactions, if the assets being exchanged do not otherwise have scarcity value, recognizing the barter transaction is plain and simple fiction. If the assets being exchanged are in substance the same product--advertising space for advertising space in a world where the advertising inventory otherwise would not have been sold to an unaffiliated entity for cash—it’s fiction to reflect such a transaction in the financial statements as revenue.

This is not to say a barter transaction is a bad business decision. They often can be of mutual benefit to both companies. But for a barter transaction to have validity in a company’s financial statements, I believe there must be scarcity value to the asset being transferred, and there should have been an equivalent ability to monetize the asset in a cash transaction with an unaffiliated third party. Likewise, the reverse end of the

exchange must be an asset or service that the company otherwise would have purchased in the ordinary course of business. If both conditions are met, there is an alignment of interests with a financing technique used to effect the transaction. In this case study, it's more likely that the motivation was nothing other than to create fictional revenue momentum. Not only is this misleading to financial statements users, it can lead to practices in which bookkeeping is the primary consideration, not maximizing long-term economic return.

As to the financing event, there are two ways to approach it.

From a business perspective. Large adoptions of a company's product or service by industry leaders are hugely relevant and valid in their own right. The company should focus on articulating the near- and long-term implications of the deal with wamSports. How will this affect gaining new customers? How will the company generate cash-based revenues from these deployments? What is the revenue cycle—one-time or annuity revenue? What are the future product extensions?

From a financial perspective. If the public market financing event depended on the company's ability to show a barter transaction as revenue, then it is my opinion that the company is not yet ready to be publicly held. If a company is stretching to reflect a single transaction in its financial statements as a prelude to an initial public offering, it's highly unlikely that the company has sufficient visibility to its financial prospects to be a public company. The fact pattern in this scenario is more akin to a company still in the early stages of evolution—in which private equity financing is more appropriate. The barter transaction summarized in the case study does not have economic underpinning and is of limited value in assessing future revenues to be generated by the product.

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"One option for eCrawler.com is to restructure its deal with wamSports to receive cash instead of advertising... and to pay cash for advertising services from other Internet companies."

The eCrawler.com case presents an Internet company shortly before a planned initial public offering. The chief financial officer is facing pressure from the chief executive officer to recognize revenue from two deals that do not meet the requirements of EITF No. 99-17, *Accounting for Advertising Barter Transactions*. The case suggests the business has a great future developing customized search engines that provide superior search results.



This future is in question, however, if the revenue targets are not met before the IPO. My commentary addresses a number of issues that the controller should consider, based largely on research findings in the accounting literature.

Recognizing Revenue

The case suggests that the wamSports deal does not meet the EITF No. 99-17 criteria for recognizing revenue. eCrawler.com receives advertising in exchange for allowing wamSports users access to a customized search engine. The case also suggests eCrawler pays wamSports three times as much as it receives, so its net exchange is one in which eCrawler gives up cash and support of a search engine for advertising. The EITF criteria require recognition to occur at the fair value of what is given or received if it can be reasonably determined. The difficulty with the present transaction comes in valuing the advertising that eCrawler receives: This could be stated at many possible values if the Securities and Exchange Commission did not require an historical basis for the recognized amount.

One option for eCrawler.com is to restructure its deal with wamSports to receive cash instead of advertising, and to acquire advertising and marketing services from other Internet companies for cash. This would provide a more objective basis for valuing its revenues and costs.

The IPO

If that is not possible, eCrawler must then consider whether it can undertake the IPO as planned. Investment bankers involved in underwriting high tech IPOs indicate that a key factor in timing is having a financial model and related metrics that show consistent progress and predictability. These numbers need not comply with generally accepted accounting principles and may rely on non-financial data. eCrawler could consider documenting its progress using non-financial metrics. Research by Trueman, Wong and Zhang (2000) documents that investors use both financial and non-financial measures to value Internet firms. Specifically, gross profits have significant explanatory power for share prices, and the number of visitors to a Web site and the number of page views have explanatory power after controlling for gross profits. These findings indicate that investors in Internet companies access a rich set of information rather than relying exclusively on financial measures.

eCrawler could also consider presenting pro forma results showing what past revenues would have been if reported under the new standard. This may show a trend in revenue growth that is similar to what would be found under more aggressive accounting. To the extent that the revenue numbers are conservative, they can disclose information about deals that are being done for which revenue cannot yet be recognized, similar to order backlogs in manufacturing. Management needs to convey the essence of its financial story to its bankers and investors: how the financial model will translate into profits over time and what assumptions are being made in projections. Management should recognize, however, that the financial statements are not the only channel for communicating with bankers, analysts and investors. Management also needs to consider the future as well as present consequences in setting its reporting policy. If there is a gamble associated with



the realization of the advertising “revenue,” investors should be made aware of this so they receive an accurate picture of eCrawler’s earnings quality.

The controller should have a plan for what to do if the IPO is postponed. For example, the company’s cash position may be sustained through bank loans or by slowing growth. Although this may seem calamitous from the founder’s perspective, it is much less so than going public too soon and facing ever-increasing pressure to meet revenue targets and potential loss of wealth for the founder and eCrawler’s investors.

Research Literature

Literature on market efficiency indicates that prices aggregate information with considerable efficiency. Although several research studies find that investors misestimate the persistence of earnings, cash flows and accruals, the evidence also indicates that prices initially reflect a significant amount of the information in earnings and reflect it fully within a year. There is also substantial evidence that investors are fairly sophisticated in interpreting accounting numbers and that when there is adequate disclosure, investors place more weight on the components of earnings that are more persistent. For example, Beaver and McNichols (1998; 2000) find that investors anticipate over- and under-reserving by property casualty insurers, and assign lower (higher) share prices to those that underestimate (overestimate) their future claim losses, all else equal. This literature suggests that revenues that are not sustainable will ultimately be identified by investors and discounted relative to more sustainable earnings.

Another large part of the literature examines the behavior of share prices following IPOs. The research documents that newly public companies underperform their more seasoned counterparts significantly.⁸ Some researchers have hypothesized that this occurs because companies overstate their earnings before going public, and provide evidence consistent with that hypothesis.⁹ However, Beaver, McNichols and Nelson (2000) found no evidence to support this in their sample of property casualty insurers surrounding initial public or seasoned equity offerings. Lin and McNichols (2000) find that IPO companies receive overoptimistic growth forecasts and overly favorable recommendations from analysts affiliated with their underwriters, suggesting that investors may have less objective analyst coverage for these companies than for non-offering companies. Jones (1998) finds that the likelihood of shareholder suits increases significantly for businesses reporting revenue restatements. These findings suggest that newly public companies have a higher probability of experiencing negative returns and are therefore at higher risk of a shareholder suit, which would be increased even further with aggressive revenue recognition practices.

Other literature suggests that investors place a higher value on businesses that provide more disclosure to investors.¹⁰ Frankel, McNichols and Wilson (1995) find that companies accessing public capital markets are more likely to provide voluntary earnings

⁸ See Ritter (1991), Loughran and Ritter (1995) and Brav, Geczy and Gompers (1999).

⁹ See Teoh, Welch and Wong (1998) and Rangan (1998).

¹⁰ See Merton (1987) and Botosan (1997).



forecasts. They are less likely to do so immediately before securities offerings, however. Furthermore, forecasts issued before offerings are unbiased, suggesting that the legal sanctions associated with misleading investors before an offering are a significant deterrent to more optimistic projections.

Finally, research by Kasznik and McNichols (2001) documents that companies that consistently meet analysts' expectations are valued more highly by investors than would be expected based on their earnings. Companies meeting expectations in only one or two periods are valued based on their earnings but do not receive a reward for meeting expectations. Thus investors appear to reward companies that provide disclosure that allows analysts to more accurately set expectations that the company consistently meets.

Credibility First

To summarize, extant research suggests that any benefits to recognizing the revenue of the wamSports deal are likely to be short-lived and that the risks to the company and its stakeholders are considerable. The controller can best serve the company's interests and those of its shareholders by establishing credibility with the investment community and helping them to understand the promise of its technology, its business model and how its financial and non-financial measures reflect its progress and prospects.