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Fraud Risks from the New Revenue Recognition Standard and the Capitalization of Internally Generated Intangible Assets at the Time of Creation

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ABSTRACT

This research provides an overview of the scheme, its risks, and how it might be avoided. To demonstrate the data, the new revenue recognition standard is examined, and a summary of the scheme is given, as how it will "assist companies" in resolving this transaction or series of transactions. The article goes on to discuss the current accounting rules for intangibles developed internally. Authors show that, although matching the definition of an asset, organization are unable to capitalize internally developed intangible on the balance sheet since they share some of the same characteristics as an asset.Internally formed intangibles, on the other hand, are not permitted to be capitalized by regulatory bodies. There have been several efforts in the past to capitalize on research and development costs, but these attempts have been minimal and have been overturned by regulators. The logic revolves around valuing such internal costs and their potential to generate revenue in the future.However, authors agree that, provided the opportunity, every organization will attempt to capitalize such expenses as assets on its balance sheet, thus increasing the company's net value. That is, if such an opportunity exists, it will be used as one of the primary motivators to seek capitalization.Even if there were motivation and a justification in the past (before the new revenue recognition standard), there was no opportunity.

Keywords: Revenue Recognition Requirement, Fraud Risk, Capitalizations, Intangible Assets.

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1. Introduction

This research examines the underlying fraud risks connected with the recently implemented revenue recognition standard and the valuation of internally developed intangibles at a development stage. After a long wait, this new accounting standard became applicable in the first quarter of 2018 (FASB ASC 606, 2016) (Shoemaker, 2019), (Tysiac, 2019).As a catalyst for recognition, the new legislation places a greater focus on the transfer of ownership of goods and services.Businesses must be able to "recognize income as a transfer or promised good/services to consumers in a sum that indicates the consideration (payment) to which the company plans to be entitled in return for such items or services" in general (FASB ASC 606, 2016). (American Institute of Certified Public Accountants, 2016).The authors believe that by adopting this revenue recognition standard, organizations will be able to employ a controlled shifting transaction to pass the cost of internally developed intangibles to third parties (at the point of creation).If there is no company-level control (as there is in the case of managed entities, such as subsidiaries subject to consolidated deleting entries), the third party could “sell” these intangibles back to the initiating party, bypassing the SFAS142 rules on internally produced properties (2001).Because the new standard's revenue recognition restriction does not apply to entities (but does apply to transactions), such a transaction would not be regarded a related party transaction and would not be eliminated in the normal course of financial reporting.However, this strategy carries a high risk of fraud, and companies' regulatory and supervisory bodies must be informed.

Companies will use the new revenue regulation to capitalize on previously un-recordable internally produced intangibles, thanks to the new revenue regulation. It's important to note that,we had to talk about intangibles that are either in the research/planning stage or as we call them, "at point of development" (i.e., not yet produced and expensed intangibles).To clarify, this revenue recognition allows businesses to take advantage of a flaw in the norm to report internal intangibles on the balance sheet by simulating an external transaction by using the majority of their capital and skills to produce the object. The following is the hypothesis that was used in this study:

H: Companies will now report internally created intangibles on their balance sheets by shifting expenses and repurchasing them back from an uncontrollable entity at the point of creation, thanks to new revenue recognition requirements.

These hypothesis problems are investigated and answered using a theoretical approach. That is, authors look at the principles and our current understanding of how they apply to intangibles accounting. This study may be used to develop recommendations or provide guidance to supervisory bodies to fix the revenue recognition accounting standard's flaws.For this paper, accounting principles are primarily used to formulate the claims that will be used to deliver and prove the hypothesis. As a result, this paper has its own set of limitations, which we, attempt to discuss. Due to the novelty of this revenue and accounting principle, there has been little research on the revenue standard's ability to handle the selling of intangibles in a regulated transaction. The majority of the theoretical foundations used in this study are focused on our current understanding of accounting rules and how they can be implemented. Any applicability based on principle will be avoided.Rather, we will apply the accounting rules exactly as they are written, without relying on any other interpretation. The purpose of the revenue standard is to set the tone and ground rules for revenue recognition.Something outside of the reach will be interpreted as such.We believe that the new revenue recognition standard has opened up new ways for accountants to use creative accounting to report previously capitalized internally produced intangibles on the balance sheet through the use of a managed transaction scheme to repurchase intangibles.As a result, if management participates in such a complex system, the two accounting principles would be implemented inconsistently, with at least one being non-compliant. The authors do not discuss the option of preference between the two as part of this analysis, but we do aim to demonstrate that these two accounting principles in terms of their responsibility to this scheme cannot coexist.As a result, an incentive has arisen, and businesses can now use it to document previously un-recordable properties. This method cannot be considered fraudulent in and of itself. Internal intangibles will be capitalized if management follows the guidelines for the latest revenue recognition. As a result, accountants and regulators should have a more open and frank dialogue about these underlying issues.

From a historical viewpoint, company management has an intrinsic propensity to manipulate earnings to meet a set of predetermined goals or earnings. This exploitation could take many forms, but it could also include the manipulation of economic events and their publication.Companies in the United States are required to register under U.S. Generally Accepted Accounting Principles (GAAP). Companies should exercise proper judgment if they calculate to explain the assumptions they used to arrive at the value. This equation, when applied to GAAP, allows for discretionary actions.There should be a strong distinction between "unfaithful" GAAP application and "fair" GAAP application. The secondary is unlikely to be a scam in and of it. Accounting and valuing intangibles have always come with their own set of financial and fraud risks. Internally produced intangibles are currently expensed as incurred under existing regulations.As a result, expensing the costs of these properties carries a low risk (since this would be viewed as a Non-GAAP application and also due to the substance of the transaction). We provide a historical perspective on intangible frauds in this section.This isn't an exhaustive list, but it gives a clear historical context and allowscomparing it to the proposed fraud scheme concerning the latest revenue recognition standard.

Many businesses have attempted to capitalize on intangible assets such as start-ups, ads, or R&D in the past. Computer Science Corporation (among others) is an example of this (Albrecht, 2011). They contend that these expenses are still in the planning stage and should be classified as deferred charges against potential revenues (Albrecht, 2011).In certain instances, this method may be compliant with GAAP. The Computer Science Corp. capitalized on the production costs associated with their key product “Comp-ticket” (Albrecht, 2011). This capitalization was used to mitigate potential revenue generated by the selling of this new product.However, the organization began to lose some of its most important clients, and the previously forecasted profits never materialized (Albrecht, 2011). As a result, deferring the intangibles is considered unacceptable.It's important to remember that fraudulent intangible reporting doesn't happen overnight. Companies will continuously capitalize relatively small charges as a form of earnings control without being caught. The following is an example of a fraud case involving WorldCom, as mentioned by the SEC in their report:The SEC claimed in its amended complaint against WorldCom that the company overstated its revenue in its financial statements by approximately $9 billion... WorldCom reportedly overstated its earnings by improperly reducing its operating costs by capitalizing those expenses as cash. WorldCom is a company that specializes in providing (U.S. SEC, 2002).

The capitalization price of externally produced or externally acquired intangibles is relatively low risk as long as there is an arm's length (third party transaction). The valuation and impairment of externally purchased goodwill are the key fraud threats for intangibles.The difference between the purchase price of the acquired business and the fair value of the acquired assets and liabilities is used to measure externally generated goodwill. As a consequence, there is a chance of mispricing since the fair value is subject to third party assessment.Furthermore, once goodwill assets are capitalized on the balance sheet, they are susceptible to impairment. The method for determining impairment is based on the acquirer's later valuation of the acquired business. This method has a high risk of being defrauded.However, since externally acquired intangibles (and their goodwill) are outside of our reach, Authors search for companies that can capitalize the "capitalized intangible." As a result of the introduction of a new revenue accounting standard, such an opportunity has emerged. It is our responsibility as researchers and clinicians to draw attention to it.There have been few instances of fraud involving internally produced intangibles or cases where management has capitalized on the internal expense of intangibles. They are, however, primarily covered by the NON-GAAP umbrella, making them more readily detectable.

2. Fraud Risks and Analysis

Companies should only capitalize or report the costs incurred to build or generate intangible assets as a result of an external transaction under current accounting regulations for intangible assets (SFAS142, 2001). The fair market price paid by the firm at the time of asset acquisition determines the cost of capitalization.Internally produced intangibles are deducted from earnings (Fraser, 2018; SFAS142, 2001). This expensing results in a major difference in the accounting treatment and company valuation. We can see this firsthand by comparing the book values of companies that follow US GAAP and their respective stock values, which are measured using the market price of outstanding shares.We accept that there are a variety of factors that could explain such differences, including intangible valuation or lack thereof, the different basis used in asset/liability valuation using US GAAP V/s consumer perception of these values, and so on (Lev, 2019; Nichita, 2019).However, it is important to remember that the development of U.S. GAAP, as any accounting language, takes into account the viewpoint of a competent and rational individual when determining asset and liability valuation methods. As a result, there would be a disparity between asset and liability valuations, but it should not be substantial enough to cause significant discrepancies.Of course, there's the element of speculation. However, if the stock has low volatility, such a consideration may be discounted as an explanation. As a result, such products or intangibles are not included in the value of businesses.Any efforts to incorporate internally produced intangibles into the balance sheet should be applauded, as they will help to close the valuation gap. Many valuations have been suggested in recent literature to deal with these internally developed intangibles.One method is to measure the company's market value based on its year-end stock prices and compare it to the balance sheet's book value (Petkov, 2019).The resulting discrepancy should be allocated accordingly between book and fair value of measurable tangible/intangible assets/liabilities as stated on the balance sheet, and all else to internally generated intangibles, with any remaining funds going towards these intangibles (Petkov, 2019).This method has flaws because it encourages businesses to increase the fair value of their stock to reach optimum allocation. Furthermore, given the market's uncertainty, such a strategy could be considered ineffective.Companies are rewarded for reporting any internally produced intangibles on their balance sheet, as previously stated. Any of these benefits aren't directly related to false reporting. It's important to remember that accounting regulation aims to increase the transparency of economic activity impacting an organization over time.To put it another way, regulators develop or improve accounting language to help businesses view their results more straightforwardly and consistently. However, there seem to be some contradictions between the general accounting premise and the relevant legislation in the case of internally developed intangible assets.

The regulators might argue, have consistently remained on the sidelines. Looking at the concept of an asset, for example, one can see that these products must meet the following criteria (SFAS 6, 1985):

a) The potential to generate sales in the future
b) Possibility of influence
c) The past's outcomes.

Internally developed intangibles can easily be argued to meet the asset criterion.The money invested in developing an intangible would help the business in the long run. The item is subject to regulation and the corporation has the authority to determine whether or not to continue using it and how to use it properly. I may also demonstrate an audit trail since the expenses Ire spent in the past. However, I am unable to consider these costs as an advantage under existing regulations (SFAS142, 2001). Given the met concept, any company's management could find the accounting treatment as unsuitable (by evaluating the met conditions of an asset and the incompatibility with internally intangible assets).

Furthermore, the company will argue that it does not adequately allow them to demonstrate their true economic conditions for the period. This claim encourages businesses to find ways to get around the rules and record the un-recordable intangibles produced internally. It was almost impossible to carry out this procedure in the past.With the current revenue recognition standard, however, there is also the possibility of shifting the expense to an outside entity in a managed contract and then repurchasing the costs as an asset. The updated revenue recognition norm and how it relates to intangibles are discussed in the following section. I've made some significant improvements to the way I account for sales. Revenue was previously known at the points of transition of ownership threats, which could occur at a single point in time or over sometime. This model is being replaced by the new regulation, which places a greater focus on the transfer of control of goods and services as the trigger for recognition. In general, the new standard's fundamental reform will encourage businesses to (AICPA, 2018):Recognize revenue to represent a transfer of products or services to consumers in a sum that represents the consideration (payment) to which the company intends to be entitled in return for such goods or services (FASB ASC 606-10-05-3). According to FASB ASC 606-10-05-4: The following measures are used to consider sales by the core principle:

a) Determine which contract(s) have with the client.
b) Determine the contract's performance obligations.
c) Establish a purchase price.
d) Assign the purchase price to the contract's performance obligations.
e) Revenue is recognized as or when the company fulfills a performance duty.

The main cause, according to this new standard, is the transfer of control rather than the risk (Hepp, 2018; Jonick, 2018; Lyons, 2018). As a result, in the case of services, sales are recognized at the point of control transfer; the other company's right to collect the activity. The contract price can be interpreted in a variety of ways depending on the services rendered.A theoretical question arises: is it feasible, and what are how businesses might transfer resources to an outside entry to produce an intangible product? As a result, a new scheme for recording internally produced intangibles that would otherwise be expensed has been proposed.

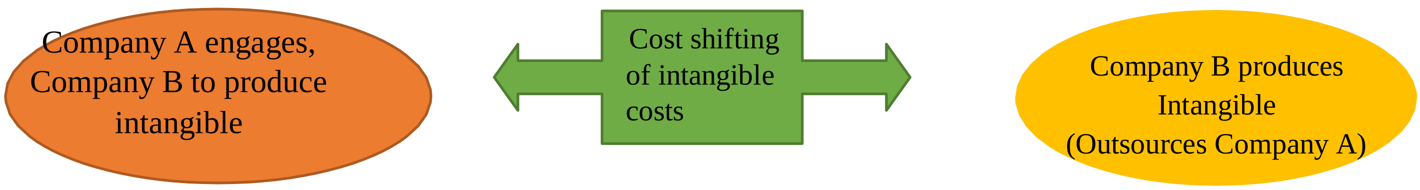

Illustration One: A cost transfer from A to B is seen, followed by a cost transfer from B to A.

In Illustration One, Company A hires Company B to create an intangible asset that it would not have created otherwise. Since the two firms are unrelated, and trade between them will not be required to be avoided. The commodity would be managed by Company B, and the intangible would be created by Company C. Company B is highly unlikely to have the necessary expertise in this field.Company B will outsource the job to Company A in this case. There will be another deal for Company A to provide outsourced work to Company B in this case. When B has finished the product (with the help of A), they will deliver it to Company A as finished goods. Since this is an outside/external purchase, the intangible must be registered on the balance sheet.

This scheme provides businesses with the requisite "accounting vehicle" to document the un-recordable.The transition of risks from the seller to the buyer used to be the primary source of revenue. Under the new legislation, revenues are remembered at the time of power transition. In the above scenario, both companies will be responsible for demonstrating control over the operation. If we believe they collaborate, they may easily and, more importantly, record these sequences of events without being detected. We don't need to exclude the transaction from either company's books because they are unrelated. Company B will acknowledge revenue after completing the agreed-upon contract to build the intangible. They will deliver the agreed-upon commodity to A once the intangible was completed.Company A could avoid FAS142 rules on internally produced intangibles by using this scheme and capitalizing the expense as though it's an external purchase.

Companies may restructure costs to the balance sheet by simulating an external purchase with a third party under the proposed scheme. This transaction may be "candy wrapped" in current accounting regulations, but it would violate US GAAP in general. As a result, businesses must recognize this as a chance of financial misreporting fraud.Again, from a fraud standpoint, Authors remember that the incentive triggers have changed as a result of the latest revenue recognition requirement and its potential to enable such schemes to be carried out. These causes did not occur in the past. With the current legislation, as stated above, businesses will continue to use US GAAP while still recording un-recordable internally generated revenue.Companies may perform tasks to mitigate the risk. Simply identifying this as a fraud risk and thoroughly testing for this possibility is one example. Furthermore, supervisory bodies must be made aware of the cost-shifting scheme and must be more vigilant in their review procedures.

3. Conclusion

The underlying fraud risks associated with the newly adopted revenue recognition standard with the capitalization of internally created intangibles at a point of development are examined in this study.The authors believe that by adopting this revenue recognition standard, organizations will be able to employ a controlled shifting transaction to pass the cost of internally developed intangibles to third parties (at the point of creation). Companies will restructure costs to the balance sheet by simulating an external purchase with a third party under the proposed scheme.Since this is an outside/external transaction, the intangible must be registered as an asset on the balance sheet. This action provides enterprises with the necessary "accounting vehicle" to record the un-recordable. This scheme appears to be in breach of US GAAP. As a result, businesses must recognize this approach as a potential source of financial misreporting fraud.Authors drew attention to this scheme and the fraud threats it poses. We also suggested a course of action for correcting or mitigating certain risks. Such action can involve but is not limited to, educating businesses of these potential risks and establishing appropriate procedures to resolve them.

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