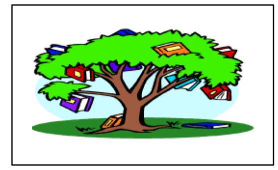
Toward Business Literacy: Accounting Outlines



Revenue Recognition

Revenue is a measurement item that lets a company know what it is getting in return for the efforts exerted or the goods it surrenders.

Revenue is recognized when it is:

- *Realized*: when goods or services are exchanged for cash or claims to cash
- Or *Realizable*: when assets received in exchange for sales of goods or services are readily convertible to cash
- And *Earned*: when the entity has substantially accomplished what it must do to be entitled to benefits that the revenue represents (complete process)

Applications: when to recognize revenue

- Product sales: date of sale or delivery to customer
- Services: when performed and billable
- Use of enterprise assets such as interest, rent or royalties: as time passes
- Disposal of assets other than sales: at the date of sale

Departures from the rule

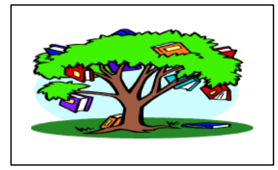
- Can recognize **earlier** if there is a high degree of certainty of the amount
- Can **delay** recognition beyond the date of sale if amount are uncertain or costs are high or if sale does not represent completion of earning process

Recognition at the point of sale

- No sale if there is a *buyback agreement*
    - A buyback agreement is when seller has the right to repurchase the asset sold
- If there is a right of return given to the buyer, the seller recognizes the sale when the privilege of return given to the buyer has lapsed (expired)
- *Trade loading* is when a wholesaler increases sales beyond the ability to resell to a retailer, accelerating profits to the present
- *Channel stuffing* is the same, just in a retail capacity- selling too much product to customers to the detriment of future years sales figures to inflate sales in earlier years

Franchises

- Various applications
    - Manufacturing←→ wholesaler
    - Wholesaler←→ retailer
    - Service sponsor ←→ retailer
- Revenue for franchisor (the one granting the franchise) comes from sale of franchise, assets and services to the franchisee (the one receiving the franchise)
- Franchisor gives franchisee: site location, income evaluation, construction supervision, signs, fixtures, bookkeeping, employee and management training, quality control, advertising and promotion
- Initial franchise fee is revenue when there is substantial performance
    - Substantial performance ends any obligation to refund



Consignment

- Revenue is recognized when consignor (person consigning goods) gets notification of from consignee (the seller)
- The inventory belongs to the consignor, not consignee
- Consignee deducts fee and expenses from sale price and remits to the consignor the remainder
- Consignor has duty of due care with the consigned goods

Revenue Recognition before delivery

- For construction contracts, military and commercial aircraft, weapons systems, and space exploration hardware
- Seller (builder) may bill the customer at intervals, with delivery (passage of title) done in installments

Construction: Percentage of Completion method

- Revenues and profits are recognized based on progress of construction
- Cost to cost: costs to date are divided by the **recent** estimate of total costs this equals the percentage complete ; multiply this percentage by total revenue to be realized on the contract to get the amount of revenue recognized in the present period
    - When changing estimate, use **new** estimate of total costs
    - Costs + gross profit earned→ Construction in Process
        1. An inventory account
    - Progress billings→Billings on Construction in Process
        2. A contra inventory account
    - If Construction in Progress are greater than the Billings → asset
    - If Billings are greater than the Construction in Progress → liability
    - Inputs: costs, hours worked, efforts devoted to contract
    - Output: Production, stories or miles completed

Construction: Completed contract method

- Revenues and profits are recognized only when contract is complete
- When changing estimates→ recognize a loss or gain
- When entire loss is expected→recognize loss in **current** period
- If profit recognized the year before and now a loss is expected on entire contract, add profit to loss figure
- JE: Loss from long-term contracts xxx
  Construction-in-progress xxx
- Rationale for completed contract
    - Short term contracts
    - Cannot meet conditions for % completion
    - There are inherent hazards in contract

Installment Sales:
recognize revenue when cash is collected—not sale

- No accrual: gross profit deferred until collection
  - Sales less cost of goods sold= gross profit
  - Find rate of gross profit and apply to cash collections
    - Rate = Gross profit / Total sale
  - Rate x Gross profit = amount of profit to recognize on the income statement and defer to future years gross profit not realized (in a deferred gross profit account)
  - Keep installment sales separate from other sales
- Seller is protected: title does not pass until all payments are made
- Justification for an installment sale: risk of not collecting accounts receivable is great enough that sale is not evidence that revenue should be recognized now –only when cash is collected
- *Front end loading* is the opposite: this is to recognize revenue prematurely
- FASB prescribes installment sale method for real estate – the title passes when the "mortgage is burned" (i.e.- no more payments)
- Repossession may occur if installment sale is deemed uncollectible
  - Write off receivable with the attached deferred gross profit
  - JE:

Repossessed merchandise	xxx
Deferred gross profit	xxx
Installment A/R	xxx

  - Asset should be acquired at fair value
- Deferred gross profit on installment sales is an unearned revenue
  - Unearned revenue is a quasi-liability
  - Three elements that compose deferred gross profit:
    - Income tax liability
    - Collection expense
    - Net income

Cost-recovery method of revenue recognition

- No profit recognized until the cash payments by buyer exceed the sellers Cost of Goods Sold

Deposit method

- Postpone recognizing sale until the sale and asset transfer occurs
- Seller treats the cash received from buyer is a deposit on a **contract** , and this is a liability that he owes to the buyer until the actual sale occurs)
- Since the seller has not performed, there is no claim on the deposit