Recognizing Revenue

Chapter 18

Intermediate Accounting
12th Edition
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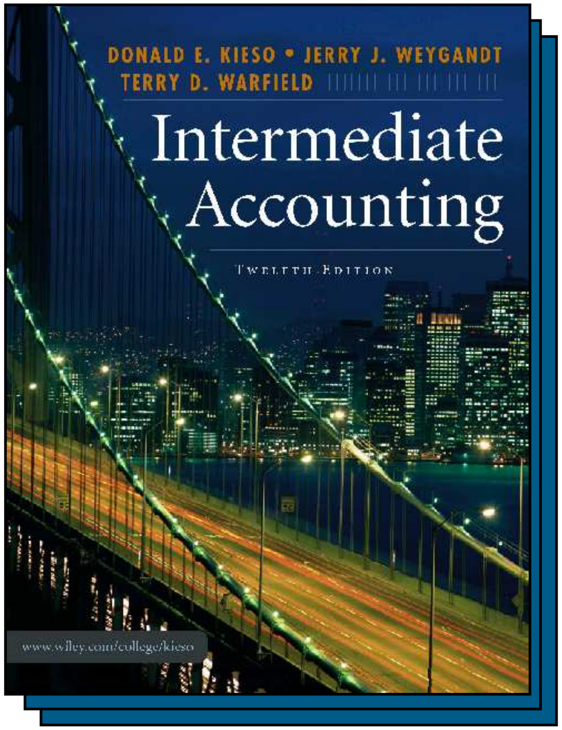

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Learning Objectives

1. Apply the revenue recognition principle.
2. Describe accounting issues for revenue recognition at point of sale.
3. Apply the percentage-of-completion method for long-term contracts.
4. Apply the completed-contract method for long-term contracts.
5. Identify the proper accounting for losses on long-term contracts.
6. Describe the installment-sales method of accounting.
7. Explain the cost-recovery method of accounting.

Revenue Recognition

Current Environment

- Guidelines for revenue recognition
- Departures from sale basis

Revenue Recognition at the Point of Sale

- Sales with buyback agreements
- Sales when right of return exists
- Trade loading and channel stuffing

Revenue Recognition before Delivery

- Percentage-of-completion method
- Completed-contract method
- Long-term contract losses
- Disclosures
- Completion-of-production basis

Revenue Recognition after Delivery

- Installment-sales method
- Cost-recovery method
- Deposit method
- Summary of bases
- Concluding remarks

The Current Environment

Revenue recognition has been the largest source of public company restatements over the past decade.

One study noted restatements of revenue:

- Result in larger drops in market capitalization than other types of restatement.
- Caused eight of the top ten market value losses in a recent year.

The Current Environment

Guidelines for Revenue Recognition

The **revenue recognition principle** provides that companies should recognize revenue

(1) when it is realized or realizable and

(2) when it is earned.

The Current Environment

Revenue Recognition Classified by Type of Transaction

Illustration 18-1

	Chapter 18	Chapter 18		
Type of Transaction	Sale of product from inventory	Rendering a service	Permitting use of an asset	Sale of asset other than inventory
Description of Revenue	Revenue from sales	Revenue from fees or services	Revenue from interest, rents, and royalties	Gain or loss on disposition
Timing of Revenue Recognition	Date of sale (date of delivery)	Services performed and billable	As time passes or assets are used	Date of sale or trade-in

LO 1 Apply the revenue recognition principle.

The Current Environment

Departures from the Sale Basis

Earlier recognition is appropriate if there is a high degree of certainty about the amount of revenue earned.

Delayed recognition is appropriate if the

- degree of uncertainty concerning the amount of revenue or costs is sufficiently high or
- sale does not represent substantial completion of the earnings process.

The Current Environment

Illustration 18-2

Departures from the Sale Basis

At date of delivery (point of sale)
"The General Rule"

Before delivery		
Before production	During production	At completion of production

After delivery	
As cash is collected	After costs are recovered

Special sales	
Franchises	Consignments

LO 1 Apply the revenue recognition principle.

Revenue Recognition at Point of Sale (Delivery)

Departures from the Sale Basis

FASB's Concepts Statement No. 5, companies usually meet the two conditions for recognizing revenue by the time they deliver products or render services to customers.

Implementation problems,

- Sales with Buyback Agreements
- Sales When Right of Return Exists
- Trade Loading and Channel Stuffing

Revenue Recognition at Point of Sale (Delivery)

Sales with Buyback Agreements

When a repurchase agreement exists at a set price and this price covers all cost of the inventory plus related holding costs, the inventory and related liability remain on the seller's books.* In other words, no sale.

* "Accounting for Product Financing Arrangements," *Statement of Financial Accounting Standards No. 49* (Stamford, Conn.: FASB, 1981).

Revenue Recognition at Point of Sale (Delivery)

Sales When Right of Return Exists

Recognize revenue only if six conditions have been met.

1. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
2. The buyer has paid the seller, or the buyer is obligated to pay the seller, and the obligation is not contingent on resale of the product.
3. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.

LO 2 Describe accounting issues for revenue recognition at point of sale.

Revenue Recognition at Point of Sale (Delivery)

Sales When Right of Return Exists

Recognize revenue only if six conditions have been met.

4. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.
5. The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
6. The seller can reasonably estimate the amount of future returns.

Revenue Recognition at Point of Sale (Delivery)

Trade Loading and Channel Stuffing

"Trade loading is a crazy, uneconomic, insidious practice through which manufacturers—trying to show sales, profits, and market share they don't actually have—induce their wholesale customers, known as the trade, to buy more product than they can promptly resell."*

* "The $600 Million Cigarette Scam," *Fortune* (December 4, 1989), p. 89.

Revenue Recognition Before Delivery

Most notable example is **long-term construction** contract accounting.

Two Methods:

- Percentage-of-Completion Method.
  - Rationale is that the buyer and seller have enforceable rights.
- Completed-Contract Method.

LO 2 Describe accounting issues for revenue recognition at point of sale.

Revenue Recognition Before Delivery

Must use **Percentage-of-Completion** method when estimates of progress toward completion, revenues, and costs are reasonably dependable and **all** of the following conditions exist:

1. The contract clearly specifies the enforceable rights regarding goods or services by the parties, the consideration to be exchanged, and the manner and terms of settlement.
2. The buyer can be expected to satisfy all obligations.
3. The contractor can be expected to perform under the contract.

Revenue Recognition Before Delivery

Companies should use the **Completed-Contract** method when one of the following conditions applies when:

1. Company has primarily short-term contracts, or
2. Company cannot meet the conditions for using the percentage-of-completion method, or
3. There are inherent hazards in the contract beyond the normal, recurring business risks.

Percentage-of-Completion Method

Measuring the Progress toward Completion

Most popular measure is the **cost-to-cost basis**.

$$\frac{\text{Costs incurred to date}}{\text{Most recent estimate of total costs}} = \text{Percent complete}$$

The percentage that costs incurred bear to total estimated costs, can be applied to the total revenue or the estimated total gross profit on the contract.

LO 3 Apply the percentage-of-completion method for long-term contracts.

Percentage-of-Completion Method

Illustration:

Casper Construction Co.

	2007	2008	2009
Contract price	$675,000	$675,000	$675,000
Cost incurred current year	150,000	287,400	170,100
Estimated cost to complete			
in future years	450,000	170,100	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer			
Current year	112,500	262,500	300,000

A) Prepare the journal entries for 2007, 2008, and 2009.

LO 3 Apply the percentage-of-completion method for long-term contracts.

Percentage-of-Completion Method

Illustration:

	2007	2008	2009
Costs incurred to date	$ 150,000	$ 437,400	$ 607,500
Estimated cost to complete	450,000	170,100	
Est. total contract costs	600,000	607,500	607,500
Est. percentage complete	25.0%	72.0%	100.0%
Contract price	675,000	675,000	675,000
Revenue recognizable	168,750	486,000	675,000
Rev. recognized prior year		(168,750)	(486,000)
Rev. recognized currently	168,750	317,250	189,000
Costs incurred currently	(150,000)	(287,400)	(170,100)
Income recognized currently	$ 18,750	$ 29,850	$ 18,900

LO 3 Apply the percentage-of-completion method for long-term contracts.

Percentage-of-Completion Method

Illustration:

	2007		2008		2009	
Construction in progress	150,000		287,400		170,100	
Cash		150,000		287,400		170,100
Accounts receivable	135,000		360,000		180,000	
Billings on contract		135,000		360,000		180,000
Cash	112,500		262,500		300,000	
Accounts receivable		112,500		262,500		300,000
Construction in progress	18,750		29,850		18,900	
Construction expense	150,000		287,400		170,100	
Construction revenue		168,750		317,250		189,000
Billings on contract					675,000	
Construction in progress						675,000

LO 3 Apply the percentage-of-completion method for long-term contracts.

Percentage-of-Completion Method

Illustration:

Income Statement	2007	2008	2009
Revenue on contracts	$ 168,750	$ 317,250	$ 189,000
Cost of construction	150,000	287,400	170,100
Gross profit	18,750	29,850	18,900

Balance Sheet (12/31)			
Current assets:			
Accounts receivable	22,500	120,000	-
Cost & profits > billings	33,750		
Current liabilities:			
Billings > cost & profits		9,000	

LO 3 Apply the percentage-of-completion method for long-term contracts.

Completed Contract Method

Companies recognize revenue and gross profit only at point of sale—that is, when the contract is completed.

Under this method, companies accumulate costs of long-term contracts in process, but they make no interim charges or credits to income statement accounts for revenues, costs, or gross profit.

Completed Contract Method

Illustration:

	2007		2008		2009	
Construction in progress	150,000		287,400		170,100	
Cash		150,000		287,400		170,100
Accounts receivable	135,000		360,000		180,000	
Billings on contract		135,000		360,000		180,000
Cash	112,500		262,500		300,000	
Accounts receivable		112,500		262,500		300,000
Construction in progress					67,500	
Construction expense					607,500	
Construction revenue						675,000
Billings on contract					675,000	
Construction in progress						675,000

LO 4 Apply the completed-contract method for long-term contracts.

Completed Contract Method

Illustration:

Income Statement	2007	2008	2009
Revenue on contracts	$ -	$ -	$ 675,000
Cost of construction	-	-	607,500
Gross profit	-	-	67,500

Balance Sheet (12/31)			
Current assets:			
Accounts receivable	22,500	120,000	-
Cost & profits > billings	15,000		
Current liabilities:			
Billings > cost & profits		57,600	

LO 4 Apply the completed-contract method for long-term contracts.

Long-Term Contract Losses

Two Methods:

- Loss in the Current Period on a Profitable Contract
  - Percentage-of-completion method only, the estimated cost increase requires a current-period adjustment of gross profit recognized in prior periods.
- Loss on an Unprofitable Contract
  - Under both percentage-of-completion and completed-contract methods, the company must recognize in the current period the entire expected contract loss.

LO 5 Identify the proper accounting for losses on long-term contracts.

Long-Term Contract Losses

Illustration: Loss on Profitable Contract

Casper Construction Co.

	2007	2008	2009
Contract price	$675,000	$675,000	$675,000
Cost incurred current year	150,000	287,400	215,436
Estimated cost to complete			
in future years	450,000	215,436	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer			
Current year	112,500	262,500	300,000

b) Prepare the journal entries for 2007, 2008, and 2009 assuming the estimated cost to complete at the end of 2008 was $215,436 instead of $170,100.

LO 5 Identify the proper accounting for losses on long-term contracts.

Long-Term Contract Losses

Illustration: Loss on Profitable Contract

	2007		2008		2009	
Costs incurred to date	$	150,000	$	437,400	$	652,836
Estimated cost to complete		450,000		215,436		
Est. total contract costs		600,000		652,836		652,836
Est. percentage complete		25.0%		67.0%		100.0%
Contract price		675,000		675,000		675,000
Revenue recognizable		168,750		452,250		675,000
Rev. recognized prior year				(168,750)		(452,250)
Rev. recognized currently		168,750		283,500		222,750
Costs incurred currently		(150,000)		(287,400)		(215,436)
Income recognized currently	$	18,750	$	(3,900)	$	7,314

LO 5 Identify the proper accounting for losses on long-term contracts.

Long-Term Contract Losses

Illustration: Loss on Profitable Contract

	2007		2008		2009	
Construction in progress	18,750				7,314	
Construction expense	150,000				215,436	
Construction revenue		168,750				222,750
Construction in progress				3,900		
Construction expense			287,400			
Construction revenue				283,500		

LO 5 Identify the proper accounting for losses on long-term contracts.

Long-Term Contract Losses

Illustration: Loss on Unprofitable Contract

Casper Construction Co.

	2007	2008	2009
Contract price	$675,000	$675,000	$675,000
Cost incurred current year	150,000	287,400	246,038
Estimated cost to complete			
in future years	450,000	246,038	0
Billings to customer current year	135,000	360,000	180,000
Cash receipts from customer			
Current year	112,500	262,500	300,000

c) Prepare the journal entries for 2007, 2008, and 2009 assuming the estimated cost to complete at the end of 2008 was $246,038 instead of $170,100.

LO 5 Identify the proper accounting for losses on long-term contracts.

Long-Term Contract Losses

Illustration: Loss on Unprofitable Contract

	2007	2008	2009
Costs incurred to date	$ 150,000	$ 437,400	$ 683,438
Estimated cost to complete	450,000	246,038	
Est. total contract costs	600,000	683,438	683,438
Est. percentage complete	25.0%	64.0%	100.0%
Contract price	675,000	675,000	675,000
Revenue recognizable	168,750	432,000	675,000
Rev. recognized prior year		(168,750)	(432,000)
Rev. recognized currently	168,750	263,250	243,000
Costs incurred currently	(150,000)	**Plug** (290,438)	(243,000)
Income recognized currently	$ 18,750	$ (27,188)	$ -

$683,438 – 678,500 = 8,438 cumulative loss

LO 5 Identify the proper accounting for losses on long-term contracts.

Long-Term Contract Losses

Illustration: Loss on Unprofitable Contract

	2007		2008		2009	
Construction in progress	18,750				-	
Construction expense	150,000				243,000	
Construction revenue		168,750				243,000
Construction in progress				27,188		
Construction expense			290,438			
Construction revenue				263,250		

LO 5 Identify the proper accounting for losses on long-term contracts.

Long-Term Contract Losses

Illustration: Loss on Unprofitable Contract

For the **Completed-Contract** method, companies would recognize the following loss :

	2007		2008		2009	
Loss on construction contract			8,438			
Construction in progress				8,438		

Revenue Recognition Before Delivery

Disclosures in Financial Statements

Construction contractors should disclosure:

- the method of recognizing revenue,
- the basis used to classify assets and liabilities as current (length of the operating cycle),
- the basis for recording inventory,
- the effects of any revision of estimates,
- the amount of backlog on uncompleted contracts, and
- the details about receivables.

LO 5 Identify the proper accounting for losses on long-term contracts.

Revenue Recognition Before Delivery

Completion-of-Production Basis

In certain cases companies recognize revenue at the completion of **production** even though no sale has been made.

Examples are:

- precious metals or
- agricultural products.

Revenue Recognition After Delivery

When the collection of the sales price is not reasonably assured and revenue recognition is deferred.

Methods of deferring revenue:

- Installment-sales method
- Cost-recovery method
- Deposit method

Generally Employed

LO 6 Describe the installment-sales method of accounting.

Revenue Recognition after Delivery

Installment-Sales Method

Recognizes income in the periods of collection rather than in the period of sale.

Recognize both revenues and costs of sales in the period of sale, but defer gross profit to periods in which cash is collected.

Selling and administrative expenses are not deferred.

Revenue Recognition after Delivery

Acceptability of the Installment-Sales Method

The profession concluded that except in special circumstances, "the installment method of recognizing revenue is not acceptable."*

The rationale: because the installment method does not recognize any income until cash is collected, it is not in accordance with the accrual concept.

*"Omnibus Opinion," Opinions of the Accounting Principles Board No. 10 (New York: AICPA, 1966), par. 12.

Revenue Recognition after Delivery

Cost-Recovery Method

Recognizes no profit until cash payments by the buyer exceed the cost of the merchandise sold.

APB Opinion No. 10 allows a seller to use the cost-recovery method to account for sales in which "there is no reasonable basis for estimating collectibility." In addition, *FASB Statements No. 45* (franchises) and *No. 66* (real estate) require use of this method where a high degree of uncertainty exists related to the collection of receivables.

LO 7 Explain the cost-recovery method of accounting.

Revenue Recognition after Delivery

Deposit Method

Seller reports the cash received from the buyer as a deposit on the contract and classifies it on the balance sheet as a liability.

The seller does not recognize revenue or income until the sale is complete.

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Percentage-of-Completion Method

Measuring the Progress toward Completion

Cost-to-cost basis

Illustrations 18-3,4,& 5

$$\frac{\text{Costs incurred to date}}{\text{Most recent estimate of total costs}} = \text{Percent complete}$$

Percent complete x Estimated total revenue = Revenue to be recognized to date

Revenue to be recognized to date - Revenue recognized in prior periods = Current-period Revenue

LO 3 Apply the percentage-of-completion method for long-term contracts.