
UNIT 5: REVENUE AND EXPENSE RECOGNITION

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5.0 AIMS AND OBJECTIVES

The aims of this unit are to discuss and illustrate revenue and expense transactions, and the accounting methods used to recognize revenue and expenses.

After you have studied this unit, you will:

- understand the theory and conceptual framework underlying revenue recognition practices.
- be familiar with the revenue and expense principles as they apply to revenue and expense recognition.
- be able to apply acceptable methods of accounting for revenue from long term construction contracts and know under what circumstances each is appropriate.
- be able to apply the installment method and the cost recovery method of revenue recognition and know under what circumstances each is appropriate.
- be familiar with the four methods of revenue recognition for service sales.

- understand the framework linking expense recognition to revenue recognition.

5.1. INTRODUCTION.

One of the most difficult issues facing accountants concerns the recognition of revenue and expenses by a business enterprise. Although general rules and guidelines exist, the significant variety of marketing methods for products and services make it difficult to apply the rules consistently in all situations.

The recognition issue refers to the difficulty of deciding when a business transaction should be recorded. The recognition issue is not always solved easily. Consider the case of an advertising agency that is asked by a client to prepare a major advertising campaign. People may work on the campaign several hours a day for a number of weeks. Value is added to the plan as the employees develop it. Should this added value be recognized as the campaign is being produced or at the time it is completed? Normally, the increase in value is recorded at the time the plan is finished and the client is billed for it. However, if a plan is going to take a long period to develop, the agency and the client may agree that the client will be billed at key points during its development.

5.2. REVENUE RECOGNITION.

The objective of any business enterprise is to generate income that will provide owners with a return on their investment. The major source of income for most enterprises is from its operation - the process of generating revenue by providing goods and services to outsiders. Operations involve the incurring of costs and expenses, and unless a satisfactory level of revenue is generated a loss or a low level of income will result, no matter how carefully costs and expenses are controlled. Consequently, the meaning of revenue and the criteria for its recognition are important not only to accountants but also to enterprise and to the users of its financial statements.

In today's more complex and uncertain business environment, accountants are faced with two tasks relating to revenue i.e. to determine when revenue is realized and the amount at which it is recognized in the accounting records. Because of new and frequently complex ways of structuring business transactions, and because of the many new products and services

developed in recent years, revenue recognition has become one of the most challenging problems in financial accounting.

SFAC No 5 defines recognition as the recording of an item in the accounts and financial statements as an asset, liability, revenue, expense, gain, or loss. Recognition includes depiction of an item in both words and numbers, with the amount included in the summarized figures reported in the financial statements

Four fundamental criteria must be met before an item can be recognized. These are definition (the item or the event must meet the definition of one of the financial statement elements (asset, revenue, expense etc), measurability (the item or event must have a relevant attribute that is reliably measurable, that is, a characteristic, trait, or aspect that can be quantified and measured. Examples are historical cost, current cost, market value etc), Relevance (information about the item or event is capable of making a difference in users decisions), Reliability (information about the item is representational faithful, verifiable, and neutral).

In addition to the above four general recognition criteria, the revenue principle provides that revenue should be recognized in the financial statements when it is earned and it is realized or realizable.

Revenues are earned when the company has substantially accomplished all that it must do to be entitled to receive the associated benefits of the revenue. In general, revenue is recognizable when the earning process is completed or virtually completed.

Earning process is the profit – directed activities of a business enterprise through which revenue is earned; such activities may include purchasing, manufacturing, selling, rendering services, delivering and servicing products sold, allowing others to use enterprise resources, etc.

Revenue is realized when cash is received for the goods or services sold. Revenue is considered realizable when claims to cash (for example, non cash assets such as accounts or notes receivable) are received that are determined to be readily convertible into known amount of cash. This criteria is also met if the product is a commodity, such as gold or wheat, for which there is a public market in which essentially unlimited amounts of the product can

be bought or sold at the known market price. In the measurement of revenue, realization generally means that a measurable transaction (such as sale) or an event (such as the rendering of services) has been completed or is sufficiently finalized to warrant the recording of earned revenue in the accounting records. The selection of the critical event indicating that revenue has been realized (earned) is the foundation of the revenue realization principle. In addition, revenue to be recognized collection of the claims from customers and clients who have purchased goods and services should be reasonably assured.

In general, revenues are recognized (formally recorded in the accounting records) as soon as all criteria are met. An accounting issue is to determine when the criteria are met for different types of revenue – generating transactions.

In making many revenue & expense recognition decisions, accountants may rely on estimates and professional judgments. For example, the amount spent for material, labor, and other services may be measured objectively, however, the continuous transformation of these cost inputs into more valuable outputs is an internal process that requires estimates based on subjective judgment. In tracing the effect of this process and portraying it in terms of birr, accountants do not have objective external evidence supporting market transactions as a basis for measurement and recording.

However, generally accepted accounting principles provide few guidelines for making estimates and for exercising professional judgment in specific revenue & expense recognition situations.

Check your progress – 1

- i. Briefly describe the three revenue realization conditions.

- ii. Briefly describe the importance of evidence, estimates and professional judgment and experience in the process of recognizing revenue & expense in the accounting records.

Stages at which revenues are recognized.

The delivery of goods or services to a customer is a significant event that occurs in virtually all revenue – generating transitions. Given this fact, three broad timing categories of revenue recognition can be identified:

1. Revenue recognized on delivery of the product or service (the point of sale)
2. Revenue recognized before delivery of the product or service.
3. Revenue recognized after delivery of the product or service.

For most companies and for most goods and services, however, revenue is recognized at the time of delivery of the goods or services to the customer: Revenue is then considered both earned and realized or realizable when the product or service is delivered.

Revenue is sometimes recognized before delivery when the earning process extends over several accounting periods and it is considered important (i.e. relevant) to provide revenue information before the earning process is complete. For example, when there is a contract to produce a product for a known birr amount that will be received when the product is delivered (i.e. it is realizable), revenue can be recognized as it is earned, before the product is delivered to the customer.

Revenue is sometimes recognized after delivery when there are concerns about the amount of revenue that will be realized. Revenue has been earned, but recognition is delayed until the amount realizable is determined. In these situations, providing reliable revenue information is considered more important than early, potentially more relevant but less reliable, revenue information.

5.2.1. Revenue Recognized at Delivery (Point of Sale)

The conditions for revenue recognition are usually met at the time goods or services are delivered. Thus, revenue from the sale of goods is usually recognized at the date of sale, which is the date the goods are delivered to the customer. Revenue from services rendered is likewise recognized when the services have been performed. This is the point – of – sale method, sometimes called the sales method or the delivery methods of revenue recognition.

Some costs associated with servicing a product or service sold with a guarantee or warranty may be incurred after delivery. When these cost can be reasonably estimated, revenue is still

recognized at the date of sale, with a provision made for future warranty cost. In this case, revenue is considered earned and realizable.

One may question why accountants choose so late a stage in the earning process to recognize revenue and thus net income.

The answer comes in two parts: (1) At any point prior to sale, the expected selling price of a product and the ability to sell it at a profit may be so uncertain that they do not constitute sufficient evidence to justify an upward valuation of the product, and (2) for most business enterprises the actual sale of a product is the most important step – the critical event – in the earning process. Until a sale is made and the product is delivered to and accepted by the customer, the future stream of revenue is both uncertain and unearned.

Shipment of goods on consignment does not constitute sales. In a consignment, goods are transferred to another party (the consignee), who acts as an agent for the owner of the goods (the consignor). Title to the goods remains with the owner until the agent sells the goods to ultimate customers, at which time a sales transaction takes place and revenue is recognized by the consignor.

1. Installment method:

Business enterprises that sell goods on the installment plan may use the installment method of accounting only when accrual accounting is not considered appropriate. The installment method is widely used for income tax purposes because it postpones the payment of income taxes until installment receivables are collected. However, the installment method is not acceptable for financial accounting unless considerable doubt exists as to the collectibles of the receivables and a reasonable estimate of doubtful accounts expense can't be made.

Under the installment method, the seller recognizes gross profit on sales in proportion to the cash collected. If the rate of gross profit on installment sales is 40%, each birr of cash collected on the installment receivables represents 40 cents of gross profit and 60 cents of cost recovery.

Repossessions are common under the installment sales method because this method is used only when there is substantial uncertainty of collection.

Revenue Recognition when Right of Return Exists

Even when a sale occurs, the recognition of revenue may be delayed because of unusual terms surrounding the sales transaction. For example, in the recorded music and book publishing industries it is common practice to give retail stores the right to return products sold and delivered to them if they cannot resell these products. When such a right of return exists, the seller continues to be exposed to the usual risks of ownership, and revenue is recognized on the date of sale only if all of the following conditions are met.

1. The seller's price to the buyer is substantially fixed or determinable on the date of sale.
2. The buyer has paid the seller, or is obligated to pay the seller and the obligations 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.
4. the buyer acquiring the product for resale has economic substance apart from that provided by the seller.
5. the seller does not have a significant obligations for future performance to bring about resale of the product by the buyer.
6. the amount of future returns can be reasonable estimated.

If these conditions are met and sales are recorded, provision for any costs or losses that may be expected in connection with any returns is made on the date of sale. The sales and cost of goods sold in the income statement exclude the portion for which returns are expected, and the allowance for estimated returns is deducted from trade accounts receivable in the balance sheet. Transactions for which revenue recognition is postponed are record as sales when the return privilege expires.

Sales on installment plan.

A sale of goods or services on the installment plan generally provides for a cash down payment and a series of additional monthly payments. Because payments extend over a long period, the seller customarily charges interest and carrying charges on the unpaid balance of installment receivables. Revenue from installment sales is recorded in the same manner as from regular sales, unless the collection of the installment receivable is not assured and there

is no reasonable basis for estimating the probability of collection. If the accrual basis of accounting is not considered appropriate, an alternative method of revenue recognition such as the installment method or the recovery method which will be discussed later must be used.

Check your progress - 2

1. What is a consignment? How revenue is recognized on consignment transactions?

5.2.2. Revenue Recognition Before Delivery

In some instances the earning process extends over several accounting periods. Delivery of the final products may occur years after the initiation of the product. Examples are construction of large ships, bridges, office buildings, and development of space exploration equipment. Contracts for these projects often provide for progress billings at various points in the construction process.

If the builder (seller) waits until the construction is completed to recognize revenue, the information on revenue and expense included in the financial statements will be reliable, but may not be relevant for decision making because the – information is not timely. In such instances, it often is worthwhile to trade – off reliability in order to provide more timely, relevant earnings information. This is the case for a company engaging in long – construction contracts.

GAAP provides two methods of accounting for revenue on long – term constructs:

1. Completed – contract method: under this method revenues, expenses, and gross profit are recognized only when the contract is completed. As construction costs are incurred they are accumulated in an inventory account (construction in progress). Progress billings are not recorded as revenues but are accumulated in a contra inventory account (billings on construction progress. At the completion of the contract, all the accounts are closed and the entire gross profit from the construction project is recognized.
2. Percentage – of – completion method: Under this method revenue, expenses and gross profit are recognized each accounting period based on the estimate of the percentage of completion of the construction project.

The percentage - of - completion method recognizes revenue on a long - term project as the contract is being completed, thus timely information is provided. However, it contains estimates and is not as reliable as information in the completed - contract method.

Management of a company has little freedom of choice in deciding between these alternative methods of accounting for long - term contracts. When estimate of costs to complete and extent of progress toward completion of long-term construction contracts are reasonably dependable, the percentage - of - completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed - contract method is preferable.

Measuring progress toward completion of a long - term construction project is accomplished with input measures or out put measures.

1. In put measures:

The effort devoted to a project to date is compared with the total effort expected to be required in order to complete the project. Examples are cost incurred to date compared with total estimated costs for the project and labor hours worked compared with total estimated labor required to complete the project. Among input measures, the cost - to - cost method is the most common. The cost - to - cost method measures the percentage completed by the ratio of the costs incurred to date to the current estimate of the total cost required to complete the project:

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

The most recent estimate of total project costs is the sum of the total costs incurred to date plus the estimated costs yet to be incurred to complete the project. Once the percentage completed has been computed, the amount of revenue to be recognized in the current period is determined as:

Current period revenue = (percent complete X total revenue from contract) – total revenue
 Recognized in
 prior periods

2. Out put measures:

Results to date are compared with total results when the project is completed. Examples are number of stories to be built and miles of highway completed compared with total miles to be completed.

Illustration: FENOTE construction company engaged into contract with a municipality to construct a 10 kilometer highway. Total contract price is Br. 900,000.

<u>Additional data:</u>	<u>Year 1</u>	<u>year 2</u>	<u>year 3</u>
Construction costs incurred during the year	Br.125,000	Br. 495,000	Br. 145,000
Estimated cost to complete the project at the end of the year	Br.625,000	Br. 155,000	0
Operating costs incurred (selling , Administrative)	Br. 15,000	Br. 30,000	12,000

Required : using the above data compute the realized profit on contract revenue for each year under the following methods of accounting for construction – type contracts:

- (a) Percentage - of –completion method (cost – to cost)
- (b) Completed – contract method.

Solution:

- (a) Percentage – of – completion method

- ♦ Revenue recognized to date = $\frac{\text{Actual cost incurred to date}}{\text{Newly estimated total cost to complete the projects}} \times \text{contract price}$
- ♦ revenue recognized for a particular year to date = Revenue recognized – Revenue recognized until the end of the previous year

There fore,

$$\begin{aligned}\text{Revenue recognized for year 1} &= \frac{125,000}{750,000} \times 900,000 \\ &= \text{Br. } \underline{150,000}\end{aligned}$$

$$\begin{aligned}\text{Revenue recognized for year 2} &= \frac{620,000}{775,000} \times 900,000 - 150,000 \\ &= 720,000 - 150,000 \\ &= \text{Br. } \underline{570,000}\end{aligned}$$

$$\begin{aligned}\text{Revenue recognized for year 3} &= \frac{765,000}{765,000} \times 900,000 - (150,000 \times 570,000) \\ &= \text{Br. } \underline{180,000}\end{aligned}$$

Fenote Construction Company

Realized Gross Profit On Contract Revenue – Percentage Of Completion Method.

For Years 1,2 And3

	<u>YEAR 1</u>	<u>YEAR 2</u>	<u>YEAR 3</u>
Contract Revenue	Br. 150,000	Br. 570,000	Br. 180,000
Costs Incurred	<u>125,000</u>	<u>495,000</u>	<u>145,000</u>
Realized Gross Profit On Contract Revenue	Br. 25,000	Br. 75,000	Br. 35,000
Operating Expenses	<u>15,000</u>	<u>30,000</u>	<u>12,000</u>
Net Income	Br. <u>10,000</u>	Br. <u>45,000</u>	Br. <u>23,000</u>

(B) Completed – contract method.

	<u>YEAR 1</u>	<u>YEAR 2</u>	<u>YEAR 3</u>
Contract revenue	Br. 0	Br. 0	Br. 0
construction costs incurred.....	<u>0</u>	<u>0</u>	<u>0</u>
Gross profit	Br. 0	Br. 0	Br. 0
Operating expenses	Br. <u>15,000</u>	Br. <u>30,000</u>	Br. <u>12,000</u>
Net income	Br. <u>(15,000)</u>	Br. <u>(30,000)</u>	Br. <u>(123,000)</u>

Some additional methods that have been proposed, and generally rejected, for the realization of revenue prior to delivery of the product are production, accretion, discovery, receipt of order, and billing.

The recognition of revenue prior to delivery generally is viewed as a departure from the revenue realization principle. Recognition of revenue on construction – type contracts under the percentage – of completion or on completion of “special order” goods has considerable theoretical and practical support.

In general, when a sale of goods is not considered to result in revenue realization, the revenue might be recognized at the following stages of the productive (earning) process prior to delivery of goods to customers:

1. Prior to production.
2. During production
3. on completion of production
4. At some other stage based, for example, on production, accretion , discovery, receipt of orders from customers, or billing of customers.

Check your progress – 3

1. What are two different approaches to determining the extent of progress toward completion of a construction project? Identify some specific types of measurement for each.

5.2.3. Revenue Recognition After Delivery

Under some circumstances the revenue recognition criteria are not met until some time after delivery of the goods or service to the customer. Such is the case when :

1. The substance of the transaction is different from the form, such as in product – financing arrangements.
2. The ultimate collectability of the sales price is highly uncertain, such as with some long – term installment sales

In such instance revenue may be recorded under the installment method, the cost recovery method , or some other method based on cash collection.

2. Cost Recovery method.

The cost recovery method is sometimes called the sunk cost method. Under this method a company recovers all the related costs incurred (the sunk costs) before it recognizes any profit. The cost recovery method is used only for highly speculative transactions when the ultimate realization of revenue or profit is unpredictable. The cost recovery method is also justified when there is uncertainty regarding the ultimate collectibility of an installment sale.

Under the cost recovery method, no profit is recognized until the cost of the products sold is fully recovered. In the period of sale, the cost of the products is deducted from sales (net of the deferred gross profit) in the income statement. The deferred gross profit also is deducted from the related receivable in the balance sheet. Collections of principal reduce the receivable, and any collections of interest are credited to the deferred gross profit ledger account. Deferred gross profit subsequently recognized as earned is presented as a separate item of revenue in the income statement.

Illustration: For installment method and cost recovery method.

On June 1, 1997, Booker productions sells a large amount of unusual merchandise to a retailer. The demand for the merchandise is unknown, the retailer is of questionable financial strength, and thus it is highly uncertain as to whether Booker will ever be paid the full sales price. The facts regarding the transaction and subsequent events are:

Sales price for merchandise	Br. 140,000	100%
Cost of merchandise sold	<u>84,000</u>	60%
Gross margin	Br. 56,000	
Cash Collected in 1997	Br. 40,000	
Cash collected in 1998	Br. 55,000	
Cash collected in 1999	Br. <u>15,000</u>	
Total cash inflows	Br. <u>110,000</u>	

At December 31, 1999, it is determined that no more cash will be collected from this transaction.

Required:

1. Show the entries to account for this transaction using the installment sales method.
2. Show the entries to account for this transaction using the cost recovery method
3. Show summary comparative income statements for all three years for both methods.

Solution:

Requirements 1 and 2 are shown in side –by – side columns to illustrate the difference between the two methods. Entries that differ between the two methods are shown in bold face.

	<u>Installment Method</u>	<u>Cost recovery method</u>
To record sales and cost of sales:		
Installment sales receivable	140,000	140,000
Installment sales	140,000	140,000
Cost of installment sales	84,000	84,000
Merchandise inventory	84,000	84,000
To record cash payments received during 1997:		
Cash	40,000	40,000
Installment sales receivable	40,000	40,000

At December 31, 1997, to record deferred gross margin and amount of realized gross margin during 1997, and to close temporary accounts:

	<u>Installment Method</u>	<u>Cost recovery method</u>
Installment sales	\$ 140,000	\$ 140,000
Cost of installment sales	84,000	84,000
Deferred gross margin	56,000	56,000
Deferred gross margin(Br. 40,000 X 0.4)	16,000	
Realized gross margin	16,000	

1998 entries to record cash received and to record realized gross margin

	<u>Installment Method</u>	<u>Cost recovery Method</u>
Cash	15,000	15,000
Installment sales receivable	15,000	15,000
Deferred gross margin	6,000+	15,000*
Realized gross margin	6,000	15,000

+ Br. 15,000 X 0.4 = Br.6,000

* since all costs have been recurred, the full amount of cash represents realized gross margin.

To record write off of amount not expected to be collected.

Deferred gross, margin	12,000+	30,000*
Loss on write –off of installment sale receivable	18,000	- 0 -
Installment sales receivable	30,000	30,000

+Under the installment sales method, the remaining deferred gross margin at the time of the write –off is Br.56,000 – 22,000 – Br.22,000 – Br.6000 = Br.12,000.

*Under the cost recovery method, the remaining deferred gross margin at the time of the write –off is Br.56,000 – Br. 0 – Br. 11,000 – Br.15,000 = 30,000

In both cases the balance in the installment accounts receivable is Br.30,000 (Br. 140,000 – Br.55,000 – 15,000)

3. Comparative income statement under the two methods are :

(In all cases, for years ending December 31).

(amount in thousands)	<u>Installment Method</u>				<u>Cost Recovery Method</u>			
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>Total</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>Total</u>
Installment sales	Br.140	Br. 0	Br. 0	Br. 140,000	Br.140	Br. 0	Br. 0	Br.140,000
Cost of sales	<u>84</u>	<u>0</u>	<u>0</u>	<u>84</u>	<u>84</u>	<u>0</u>	<u>0</u>	<u>84</u>
Gross margin	56	0	0	56	56	0	0	56
Less: Deferred margin	(56)	0	0	(56)	56	0	0	(56)
Add: Realized gross margin	<u>16</u>	<u>22</u>	<u>6</u>	<u>44</u>	<u>0</u>	<u>11</u>	<u>15</u>	<u>26</u>
Income (before write – off)	16	22	6	44	0	11	15	26
Write-off of un collectible receivable	-	-	(18)	(18)	-	-	0	0
Income	Br. <u>16</u>	<u>Br.22</u>	<u>Br.(12)</u>	<u>Br.26</u>	<u>Br. 0</u>	<u>Br.11</u>	<u>Br.15</u>	<u>Br.26</u>

In general, revenue recognition under the installment and cost recovery methods of accounting is based to a considerable extent on the timing of cash receipts.

3. Cash Collection method.

The recognition of revenue may be delayed beyond the point of sale until additional evidence confirms the sales transaction. For example, a significant degree of uncertainty may exist as to the collectibles of receivables resulting from revenue transactions, or a sales transaction may be lacking in economic substance and therefore may after inadequate evidence of revenue realization. Under these circumstances revenue is recognized as cash is collected, and costs incurred are either recognized as expense or deferred, as considered appropriate in a specific situation. An extreme application of this test of revenue realization is the cash basis of accounting described in chapter 3.

Check your progress – 4

1. Under what circumstances revenue might be recognized after the delivery of goods to customers?

5.3. REVENUE RECOGNITION FOR SERVICE SALES.

For companies that provide services rather than products, revenue recognition follows procedures similar to those for tangible goods transactions. The four methods of revenue recognition for service sales are:

1. Specific performance
2. Proportional performance
3. Completed performance
4. Cash Collection method

Specific performance.

The specific performance method is used to account for service revenue that is earned by performing a single act. For example, a real estate broker earns sales commission revenue on completion on a real estate transaction, a dentist earns revenue on completion of a tooth filling; a laundry earns revenue on completion of the cleaning.

Franchise revenue: SFAS No 45, "Accounting for Franchise Fee Revenue" deals with a particular type of service sale, franchises. It prescribes the specific performance method to account for franchise fee revenue, which a franchiser earns by selling a franchise. For revenue recognition purposes, it is often difficult to determine the point at which the franchisor has "substantially performed" the service required to earn the franchise fee revenue.

Example: Assume that on April 1, 1997, Chicago Pizza Corporation (franchisor) sold a franchise to Arthur Wilson (franchisee) for Br. 20,000 cash down and received a note that required five annual payments of Br. 8,739 beginning on March 31, 1998. The interest rate is 14% and the note therefore has a present value of Br. 30,000.

Two situations are examined:

Case A. If no additional services are to be performed by the franchisor and collectibility is reasonably assured, Chicago pizza should recognize the entire amount (the Br. 20,000 cash payment and Br. 30,000 note receivable)

As revenue on April 1, as follows:

Cash-----	20,000
Notes receivable -----	30,000
Franchise fee revenue -----	50,000

Case B. If Chicago pizza has additional services to perform for the franchisee, such as outfitting the new pizza restaurant, no franchise fee revenue would be recognized on April 1, 1997.

Rather, the entry would be:

Cash -----	20,000
Notes receivable -----	30,000
Deferred franchise fee revenue -----	50,000

On December 31, 1997, Chicago pizza would make the following entry to accrue interest on the notes receivable:

Note receivable-----	3150
Deferred franchise fee revenue (Br.30,000 X .14 X 9/12) -----	3150

Assume that Chicago completes its obligations to the franchisee in January 1998, after having spent Br.2000 in the process. The entry to record this expenditure and recognize revenue would be:

Deferred franchise fee revenue-----	50,000
Franchise service expense -----	2,000
Franchise fee revenue -----	50,000
Prepaid expense, franchise services -----	2,000

Expenditures in 1997 by the franchisor related to the franchise would be deferred as prepaid expenses until the associated franchise fee is recognized until the associated franchise fee is recognized, in conformity with the matching principle.

Proportional performance method.

The proportional performance method is used to recognize service revenue that is earned by more than a single act and only when the service extends beyond one accounting period. Under this method, revenue is recognized based on the proportional performance of each act. The proportional performance method of accounting for service revenue is similar to the percentage – of – completion method. Proportional measurement takes different forms depending on the type of service transaction.

- A. similar performance acts: an equal amount of service revenue is recognized for each such act (for example, processing of monthly mortgage payments by a mortgage banker).
- B. Dissimilar performance acts: service revenue is recognized in proportion to the server's direct costs to perform each act (for example, providing lessons, examinations, and grading by a correspondence school)
- C. Similar acts with a fixed period of performance: service revenue is recognized by the straight line method over the fixed period unless another method is more appropriate (for example, providing maintenance services on equipment for a fixed periodic fee)

Completed – Performance method.

The completed performance method is used to recognize service revenue earned by performing a services of acts of which the last is so important in relation to the total service transaction that service revenue is considered earned only after the final act occurs. For example, a trucking firm earns service revenue only after delivery of freight, even though packing loading, and transporting preceded delivery. The method is similar to the completed – contract method used for long –term contracts.

Cash collection method

The cash collection method is used to account for service revenue when the uncertainty of collection is so high or the estimates of expenses related to the revenues are so unreliable that the requirement of reliability is not satisfied. Revenue is recognized only when cash is collected. This method is similar to the cost recovery method used for product sales.

Check your progress -5

1. Define service enterprises and service transactions.

_____.

5.4. EXPENSE RECOGNITION.

After the revenue of the accounting period is measured and recognized in conformity with the revenue principle, the matching principle is applied to measure and recognize the expenses of

that period. The costs of those assets and services used up should be recognized and reported as expenses of the period during which the related revenue is recognized.

Expenses can be classified into three categories:

1. Direct expenses are expenses such as cost of goods sold that are associated directly with revenues. These expenses are recognized based on recognition of revenues that result directly and jointly from the same transactions or other events as the expenses. This is an example of applying the matching principle.
2. Period expenses are expenses such as selling and administrative salaries, which are not associated directly with revenues. These expenses are recognized during the period in which cash is spent or liabilities are incurred for goods and services that are used up either simultaneously at acquisition or soon after.
3. Allocated expense are expenses such as depreciation and insurance. These expenses are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide benefits.

The principles that provide accountants with guidelines for the recognition of expenses are

A. Association cause and Effect:

Costs may be recognized as expenses based on a presumed direct association with specific revenue. Costs that appear to be related to specific revenue are recognized as expenses concurrently with the recognition of the related revenue. Examples of costs related to specific revenue include the direct cost of goods sold or service provided, sales commission, and direct costs incurred in relation to construction – type contracts.

B. Systematic and rational allocation.

If a direct means is not available to associate cause and effect, costs may be recognized as expenses based on an orderly allocation to the accounting periods in which the costs appear to expire and presumably provide benefits received, because neither can be objectively measured.

C. Immediate recognition.

Expenses are recognized in the current accounting period when

- i) Costs incurred in the accounting period are expected to provide any future benefit

- ii) costs deferred as assets in earlier periods no longer provide benefits, and
- iii) allocation of costs to revenue or to accounting periods is impractical or is considered to serve no useful purpose.

5.5. RECOGNITION OF GAINS AND LOSSES.

Gains and losses are distinguished from revenues and expenses in that they result from peripheral or incidental transactions, events, or circumstances.

Most gains and losses are recognized when the transaction is completed. Thus, gains and losses from disposal of operational assets, sale of investments, and early extinguishment of debt are recognized in the entry made to record the transaction. For example, an entry to record the disposal of a tract of land for cash would reflect a debit to cash, a credit to land for cash would reflect a debit to cash, a credit to land (for its recorded cost), and debit to loss (or a credit to gain) on disposal.

Estimated losses are recognized before their ultimate realization if they are both probable and can be reasonably estimated. Examples are losses on disposal of a segment of a business, pending litigation, and expropriation of assets. If both conditions are met, the nature and estimated amount of the contingent loss must be disclosed in as note to the financial statements.

In contrast, gains are almost never recognized before the completion of a transaction that establishes the existence and amount of the gain.

Accounting for gains and losses reflects a conservative approach. Losses may be recognized before they actually occur, but gains are recognized before a completed transaction or event.

Check your progress – 6

1. How indirect costs recognized under the cash collection method of revenue recognition for a service transactions?

_____.

5.6. SUMMARY

Revenues are gross increase in assets or gross decreases in liabilities resulting from the profit – directed activities of an enterprise. As an element of the income measurement process, the revenue for a period is generally determined independently of expenses by applying the revenue recognition principle. The revenue recognition principle provides that revenue is recognized when the earning process is complete or virtually complete, and an exchange has taken place. The earning process is complete when revenues are realized, and realization takes place when goods and services are exchanged for cash or claims to cash (receivables). Revenues are said to be realizable when assets received in exchange are readily convertible to known amounts of cash or claims to cash.

The matching principle provides guidance for expense recognition. The matching principle states that for any reporting period, the expenses recognized in that period are those incurred in generating the revenues recognized in that period.

Most gains and losses are recognized when the related transaction is completed. Estimated losses but not estimated gains are when they are probable and can be reasonably estimated.

5.7. ANSWERS TO CHECK YOUR PROGRESS

1. (i) The three revenue realization conditions are:
 - a) Sufficient reliable evidence exists to measure the market value of the output; such evidence generally is provided by an exchange transaction between independent parties. The economic substance of the transaction indicates that an exchange has occurred; more legal form of an exchange doesn't support revenue recognition.
 - b) The earning process (the creation of goods and services) is complete or virtually complete, and all necessary costs have been incurred or may be estimated with reasonable accuracy.
 - c) Collection of the claims from customers and clients who have purchased the goods and services is reasonably assured.

(ii). Recognition of revenue and expenses in the accounting records requires “competent evidential matter,” either external or internal (or perhaps both), which frequently must be based on reasonable estimates. In the evaluation of the form and economic substance of revenue and expense transactions, accountants use professional judgment and their accumulated practical experience to determine if revenue has been earned or if expenses have been incurred.

Professional judgment and experience always are useful in the implementation of accounting principles, but these factors are especially important in the revenue and expense recognition situations. Accountant must understand fully not only the earning Process and flow of costs of a business enterprise but also its external environment before they are able to make judgments as to the integrity of transactions, completion of the earning process, future costs (if any) to be incurred in relation tot specific revenue, and the collectiblity of the revenue.

2. Consignment is the placing of goods by their owner (the consignor) on the premises of another company (the consignee). In a consignment sales arrangement, revenue is recognized and inventory is appropriately reduced when the consignor receives word that a sale has been mode.
3. The two approaches to9 determining progress two ward completion of a long – term construction project are:
 - a) Input measures like cost incurred, labor hours worked etc.
 - b) Out put measures like number of stories of a building, miles of highway etc.
4. Revenue might be recognized after the delivery of goods to customers when the sale and delivery don’t provide sufficient evidence of revenue realization.
5. Service enterprises operate in service industries and generate revenue by selling services rather than goods. The revenue generating activities of service enterprises are called service transactions.
6. When revenue from service transactions is recognized under the cash collection method, indirect costs are expensed immediately because of the substantial uncertainty surrounding the collectiblity of the revenue.

5.8 MODEL EXAMINATION QUESTIONS

PART 1. True/False

- _____ 1. Inherent in any sales transaction is an element of gain or loss.
- _____ 2. FASB concepts statement No 5 provides that revenue is recognized when
- (a) it is collected and
- (b) the earning process is complete.
- _____ 3. Accountants normally prepare a journal entry for a “contract of sales”, while a “contract to sell” is not recorded in the accounts.
- _____ 4. The difference between realized gross profit and deferred gross profit on installment sales is based on the cash collections related to the installment sales.
- _____ 5. Expenses paid by the consignor in a consignment arrangement are normally deducted from any commission earned by the consignee

PART 2. Multiple Choice

1. One of the more popular input measures used to determine the progress toward completion in the percentage – of – completion method is
- A) Revenue – percentage method
- B) Cost – percentage method
- C) Progress completion method
- D) Cost – to – cost method
2. Hartman corporation recently received a long – term contract to construct a luxury liner. The contract will take 3 years to complete at a cost of \$3,500,000. The price of the liner is set at \$5,000,000. If the cost estimates at the end of the first year are in line with original estimates, and \$1,050,000 of costs were incurred during the first year, the amount of income recognized during the first year using the percentage – of – completion method is:

- A. \$ 1,500,000
- B. \$ 1,050,000
- C. \$ 735,000
- D. \$ 450,000

_____ 3. Under the completed – contract method of accounting for long –term contraction contracts, in terms charges and / or credits to the income statement are made for

	<u>Revenues</u>	<u>Costs</u>	<u>Gross Profit</u>
A.	Yes	No	No
B.	No	No	No
C.	No	Yes	No
D.	Yes	Yes	Yes

_____ 4. For which of the following products is it appropriate to recognize revenue at the completion of production even through no sale has been made?

- A. Automobiles
- B. Large appliances
- C. Single family residential units
- D. Precious metal.

The following information relates to questions 546.

During 1990, Winters Corporation sold merchandise costing \$500,000 on an installment basis for \$800,000. The cash receipts related to these sales were collected as follows: 1990, \$191, \$191, \$450,000; 1992, \$100,000.

_____ 5. What is the rate of gross profit on the installment sales made by Writers Corporation during 1990?

- A 37.5 %
- B. 50%
- C. 60%
- D. 62.5%

_____ 6. If expenses, other than the cost of the merchandise sold, related to the 1990 installment sales amounted to \$60,000 by what amount would winters' net income for 1990 increase as a result of installment sales?

- A. \$ 240,000
- B. \$190,000
- C. \$71,250
- D. \$33,750

PART 3. Exercises

1. Ailec corporation uses the percentage – of – completion method to account for work performed under long –term construction contracts. Ailed began work under contract #7031-21, which provided for a contract price of \$3,645,000. Additional data is as follows:

	<u>1993</u>	<u>1994</u>
Cost incurred during the year.....	\$563,000	\$1,764,000
Estimated costs to complete as of December 31,	1,500,000	- 0 –

Required:

- a. What portion of the total contract price would be recognized as revenue in 1993 & in 1994?
- b. Following information was taken from the records of Brenner corporation for the year indicated. The company's year end is December 31,

	<u>1993</u>	<u>1994</u>	<u>1995</u>
Sales (on installment).....	\$450,000	\$500,000	\$620,000
Cost of sales.....	342,000	360,000	434,000
Gross profit	\$108,000	140,000	186,000

Cash receipts:

1993 Sales	\$125,000	\$280,000	\$ 45,000
1994 Sales		\$210,000	230,000
1995 Sales			250,000

Calculate the amount of Realized Gross profit on installment sales and Deferred Gross Profit to be reported in the year – end – financial statement of Brenner Corporation for the year noted.

2. Houston Company uses the installment sales method to account for its installment sales. On January 1, 1993, Houston Company had an installment account receivable from D. Fredenick son Company in the amount of \$2,300. Frederickson paid a total of \$500 on the account during 1993. However, late in 1993 Frederick son discontinued payments and the merchandise was repossessed. When the merchandise was repossessed it had a fair market value of \$720. Houston Company spent on additional \$75 to recondition the merchandise. When the repossessed merchandise was originally soled, it was to yield a 45% gross profit sale.

Required:

Prepare the journal entries on the books of Houston Company to record all transactions with Frederickson Company during 1993.

3. On November 10, year 2, painting contractors, Inc. Commended a Br. 25,000 contract to sandblast and paint several buildings for a real estates investor. The direct costs of the contract (including subcontracting for the sandblasting, paint, and salaries of workers) were estimated at Br. 20,000 On December 31, year 2. The contract consisted of a large number of dissimilar acts. Through December 31, year 2, the contract costs incurred amount to Br. 14,000 and the acts performed to date amount to at least 801. Of the total acts to be performed by painting contractors.

Compute three possible amounts gross profit that painting contractors, Inc., might recognize for the year ended December 31, years 2 on the foregoing contract.

4. Three independent eases are given below for 1995. The accounting period ends December 31.

Case A. on December 31, 1998, Zulu Sales Company sold a special machine (serial No 1713) for Br. 200,000 and collected Br. 80,000 cash. The remainder plus 10 percent interest is payable December 31, 1999. Zulu will deliver the machine on January 5, 1999. The buyer has an excellent credit rating.

Case B. On November 15, 1998, Victor Company sold a ton of its product for Br. 1,000. the buyer will pay for the product with two units of its own merchandise. The buyer promised to deliver the merchandise around January 31,1999.

Case C. On January 2,1998, Remer publishing Company collected Br. 1,800 cash for a three – year subscriptions to a monthly , Investors stock and B and Advisory. The march 1998, issue will be the first one mailed.

Required : For each case, briefly answer the following:

1. The revenue recognition method that should be used.
2. Any entry that should be made on the transaction date.
3. An explanation of the reasoning for your responses to (1) &(2)

4.9 GLOSSARY

1. Completed contract method – a method of accounting for revenue on Long – term contracts where by revenues, expenses, and gross profit are recognized only when the contract is completed.
2. Cost recovery method – is conservative method in which no profit is recognized until all costs associated with the sale item have been recovered in cash.
3. Installment sales method – A method of revenue recognition that delays recognition of gross profit until cash is collected, at which time gross profit is recognized at the gross profit rate for the original installment sale.
4. Percentage – of – Completion method – a method of accounting for revenue on long – term contracts whereby revenues and expenses are recognized each accounting period based on an estimate of the percentage of completion.
5. Realization – means that a measurable transaction or an event has been completed or is sufficiently finalized to warrant the recording of earned revenue in the accounting records.
6. Recognition the process of recording items (revenue) in the accounting records.

