Revenue Recognition

- Two conditions must exist:
  - Revenues realized or realizable
  - Revenues earned
- Requires determination of the critical event:
  - Risk of ultimately receiving a determinable amount of revenue is reduced to a minimum
  - Critical event may occur anywhere in the process of production thru cash receipt or fulfilling warranty obligations.
Revenue Recognition Methods

<table>
<thead>
<tr>
<th>Method</th>
<th>Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>Service rendered</td>
</tr>
<tr>
<td>Installment sales</td>
<td>Sale price collected</td>
</tr>
<tr>
<td>Production</td>
<td>Product completed</td>
</tr>
<tr>
<td>% of completion</td>
<td>Proportionally</td>
</tr>
<tr>
<td>Completed contract</td>
<td>Completion</td>
</tr>
<tr>
<td>Cost recovery</td>
<td>Receipts &gt; costs</td>
</tr>
<tr>
<td>Delivery</td>
<td>Delivery when cash received in advance</td>
</tr>
</tbody>
</table>

Sales Method

- Most commonly used method
- Not necessary for legal criterion of title passing
- Allowances (or offsets):
  - Returns
  - Bad debts
  - Cash discounts
  - Warranty.
Installment Sales Method

- Only used for asset sales and real estate deals
  - 1986 Tax Reform Act
- Requires a down payment with a specified series of future payments
- Gross profits recognized:
  - Time of sale (accounting)
    - Collection is reasonably assured; allowance used
  - Proportionally with each payment (tax).

Cost Recovery Method

- Seldom used
  - No reasonable basis for estimating degree of collectibility exists
- No profit recognized until cumulative receipts > costs
  - Receipts offset against costs
- Not allowed for tax purposes.
Production Method

- Market stands ready to take the product at a going firm price
- Used in some extractive and agricultural industries.

Percentage of Completion Method

- Preferred method for long-term contracts
- Recognizes income as the work progresses
  - Income recognized is a percentage of estimated total income
  - Must have reasonable certainty about costs
    » Adjust estimated profit when less income expected

- Disadvantage
  - Must make periodic estimates of ultimate costs
  - Manipulation; costs deferred to balance sheet.
Completed Contract Method

- Costs and billings accumulated
- Some overhead costs deferred to the balance sheet
- Excess of costs over billing: current asset
- Excess of billings over costs: current liability
- Method fails to reflect current performance
  – Irregular pattern of income recognition.

Example: Income Recognition Methods from Installment Sales

Assume: Sale = $20 million; cost = $16 million; payments = 5; cost of money = 12%. Amortization schedule used.

<table>
<thead>
<tr>
<th>Time of Sale</th>
<th>Installment Method</th>
<th>Cost Recovery First</th>
<th>Interest Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Costs</td>
<td>Sales Costs Sales</td>
<td>Sales Costs</td>
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</tr>
<tr>
<td>1 $20.0</td>
<td>$16.0 $3.148 $2.519</td>
<td>$3.148 $3.148 $2.400</td>
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<td>3.526 2.022</td>
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<td>5</td>
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<td>$20.0 $16.0</td>
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<td></td>
</tr>
</tbody>
</table>
Analytical Considerations of Revenue Recognition Methods

- Net income or cash flows?
- Think about:
  - Quality of earnings!
  - Cash flows!
    » A firm can go broke while making a profit!

The End