Module 5 - Revenue Recognition

- Revenue Recognition Principle states that:
  - Revenues should be recorded when:
    - The earnings process is SUBSTANTIALLY complete…the sale has been made or the service has been provided
    - Cash has been collected or collectibility is reasonably assured
  - Both parties to the transaction have fulfilled their obligations or are formally obligated to do so

Problem

Excalibur Shipping Company sells ships. Each ship sells for over $25 million. Excalibur never starts building a ship until it receives a specific order from a customer. Excalibur usually takes about four years to build a ship. After construction is completed and during the first three years the customer uses the ship, Excalibur agrees to repair anything on the ship free of charge. The customers pay for the ships over a period of ten years after the date of delivery

Problem Cont.

Excalibur Shipping Company is considering the following alternatives for recognizing revenue from its sale of ships:

1. When Excalibur receives the order
2. When Excalibur begins the work
3. Proportionately during the four-year construction period
4. After customer takes possession
5. Wait till 10-yr payment period is over

Matching Principle

- Matching Principle
  - Concept that all costs and expenses incurred in generating revenues must be recognized in the same reporting period as the related revenues

Recognized Revenue – Matched Expenses = Net Income for Period

Problem – Matching Principle

American Flag Makers Inc manufactured 15,000 flags during the 2003 calendar year. They sold 12,000 flags for $15.00 each and each flag they made cost them $8.00. They also incurred over the year $25,000 in selling expenses and $32,000 in General and Administrative Expenses. Prepare a multi-step income statement and explain how you used the matching principle concept in its preparation

Matching problem solution

American Flag Makers Inc

Income Statement

FYE 12/31/03

Revenue (12,000 X $15.00 per flag)	$180,000
Cost of Goods Sold (12,000 X $8.00 per flag)	(96,000)
Gross Profit	84,000
Selling Expenses	(25,000)
General and Administrative Expenses	(32,000)
Net Income	$ 27,000

Accrual Accounting

- Time period concept
  - The idea that the life of a business is divided into distinct and relatively short time periods so that accounting information can be timely
- Fiscal year
  - An entity’s reporting year
- Calendar year
  - 12 months ending on December 31st

Accrual Accounting

- Adjustment of raw information into refined measures of an organizations past economic performance and its current financial condition

Accrual Accounting

- Accrual versus Cash-Basis Accounting
  - Accrual-basis accounting
    - Revenue is recognized when earned with out regard to when cash is received and expenses are recognized when they match to the revenue earned
  - Cash-basis accounting
    - Revenue is recognized when the cash is received and expenses are recognized when the cost is incurred.