Chapter 6

Generally Accepted Accounting Principles; Revenue Recognition
**GAAP**

<table>
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<tr>
<th>Objectives of financial reporting</th>
<th>Useful, meaningful information for investing and credit decisions Information on future cash flows</th>
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<tr>
<td>Qualitative characteristics of accounting information</td>
<td>Understandability, relevance, reliability, comparability</td>
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<td>Elements of financial statements</td>
<td>Assets, liabilities, equity/net assets Revenues, expenses, gains, losses</td>
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<tr>
<td>Recognition and measurement criteria</td>
<td>Asset/liability measurement – historical cost, fair value basis Revenue/expense recognition – cash basis, accrual method</td>
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<td>Assumptions</td>
<td>Entity concept, periodic concept, going concern</td>
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<td>Principles</td>
<td>Unit of measure, matching, consistency, disclosure</td>
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<td>Constraints</td>
<td>Materiality, conservatism, industry practices, cost/benefit</td>
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<td>Specific accounting policies, procedures and rules</td>
<td>CICA Handbook</td>
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Revenue Recognition

❖ When may a company recognize revenue from a transaction?
❖ Three questions:
Revenue Recognition

❖ When may a company recognize revenue from a transaction?

❖ Three questions:

1. Have we transferred to the buyer substantially all of the risks and rewards associated with the product sold or service provided?

Why did I buy this thing?
Revenue Recognition

❖ When may a company recognize revenue from a transaction?

❖ Three questions:

1. Have we earned the right to proceeds from the sale because we completed our share of the transaction?

The brochure said this would be a LUXURY cruise!

I am not paying for this!
Revenue Recognition

❖ When may a company recognize revenue from a transaction?

❖ Three questions:

③ Is the collectibility of proceeds from the sale assured with a reasonable degree of certainty?

Don’t worry, Chester! I’ll pay up eventually.
Revenues vs. Cash Receipts

Customer selects goods.
Revenues vs. Cash Receipts

Customer selects goods.

Customer does not have the cash to pay now . . .
Revenues vs. Cash Receipts

Customer selects goods.

Customer does not have the cash to pay now . . .

Seller agrees to deliver now, and receive cash later.
Revenues vs. Cash Receipts

Customer selects goods.

Usually, 30 days later, seller receives cash.

Customer does not have the cash to pay now . . .

Seller agrees to deliver now, and receive cash later.
### Revenue Recognition Methods

<table>
<thead>
<tr>
<th>Before Sale (During/End of Production)</th>
<th>Time of Sale</th>
<th>After Sale (Cash Collection)</th>
</tr>
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<tbody>
<tr>
<td>Percentage-of-completion method</td>
<td></td>
<td>Instalment sales method</td>
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<tr>
<td>Completed-contract method</td>
<td>Point-of-sale method</td>
<td>Cost recovery method</td>
</tr>
<tr>
<td>Completion-of-production method</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Expense Recognition

❖ When may a company recognize an expense?
❖ Three questions:
Expense Recognition

❖ When may a company recognize an expense?

❖ Three questions:

Have we included in our income statement all of the costs and expenses associated with the benefits (revenues) we realized during the year?

The Matching Principle
6 Expense Recognition

❖ When may a company recognize an expense?

❖ Three questions:

② As we prepared these financial statements, have our judgments and estimates been appropriately conservative?
Expense Recognition

❖ When may a company recognize an expense?
❖ Three questions:
   ③ Do all of our assets still have the potential to earn future cash flows equal to their current costs?
Matching Principle

Revenues (sales) generated are matched by:

Prior Period Costs:
- Cost of goods sold (inventory)
- Insurance expense
- Amortization expense

Current Period Costs:
- Commissions expense
- Advertising expense
- Operating expenses
- Interest expense

Future Period Costs:
- Warranty expense
- Bad debts expense
How Conservative/Aggressive Should I Be with My Estimates?

Our employees had computer training classes before we opened the business.
6

How Conservative/Aggressive Should I Be with My Estimates?

Should we be conservative and expense the training costs or be aggressive and record the costs as an asset with future value?
The **conservatism principle** advocates selecting the method that will not create surprises in the future.
Do All Assets Have the Potential to Earn Cash Equal to Their Carrying Value?

GAAP requires that assets having no future cash-earning benefit be charged off as an expense.
6 Income Statement Classification

- Income statement format:
  - List all revenues.
  - Deduct various categories of expenses.
  - Compute net income.

SERVICE Company
Income Statement
For the Period Ending MM-DD-YY

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td></td>
</tr>
<tr>
<td>Expense #1</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Expense #2</td>
<td>XXX</td>
</tr>
<tr>
<td>Expense #3</td>
<td>XXX</td>
</tr>
<tr>
<td>Total Operating Exp.</td>
<td>XXX</td>
</tr>
<tr>
<td>Net Income from</td>
<td></td>
</tr>
<tr>
<td>Continuing Operations</td>
<td>$ XXX</td>
</tr>
</tbody>
</table>
Income Statement Classification

- **Income statement format:**
  - List all revenues.
  - Deduct various categories of expenses.
  - Compute net income.

**MERCHANDISE Company**
Income Statement
For the Period Ending MM-DD-YY

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>XXX</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td></td>
</tr>
<tr>
<td>Expense #1</td>
<td>$ XXX</td>
</tr>
<tr>
<td>Expense #2</td>
<td>XXX</td>
</tr>
<tr>
<td>Expense #3</td>
<td>XXX</td>
</tr>
<tr>
<td>Total Operating Exp.</td>
<td>XXX</td>
</tr>
<tr>
<td>Net Income from Continuing Operations</td>
<td>$ XXX</td>
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</tbody>
</table>

6 Terminology and Concepts

Gains & Losses
Gains and losses result from sales not in the ordinary course of business.
Terminology and Concepts

If proceeds greater than carrying value:
- Gain

If proceeds less than carrying value:
- Loss
Gain and Loss: Example

- Bob’s Boats, Inc. sells fishing boats. On April 5, Bob’s Boats sold land the company owned in another county to Eve Development Corp. for $20,000.
- The land has a carrying value on Bob’s books of $16,000.

Should the $20,000 received from Eve Development be recorded as revenue?
Gain and Loss: Example

Bob’s Boats, Inc. sells fishing boats. On April 5, Bob’s Boats sold land the company owned in another county to Eve Development Corp. for $20,000.

The land has a carrying value on Bob’s books of $16,000.

Should the $20,000 received from Eve Development be recorded as revenue?

No. The sale of land by Bob’s Boats is not a sale in the ordinary course of business.

The gain/loss on the transaction should be computed and reported separately.
Gain and Loss: Example

- Bob’s Boats, Inc. sells fishing boats. On April 5, Bob’s Boats sold land the company owned in another county to Eve Development Corp. for $20,000.

- The land has a carrying value on Bob’s books of $16,000.

What is the gain or loss on the sale that should be recognized by Bob's Boats?
Gain and Loss: Example

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What is the gain or loss on the sale that should be recognized by Bob's Boats?

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<tr>
<th>Description</th>
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<tbody>
<tr>
<td>Proceeds</td>
<td>$20,000</td>
</tr>
<tr>
<td>Carrying Value</td>
<td>16,000</td>
</tr>
<tr>
<td>Gain on Sale of Land</td>
<td>$4,000</td>
</tr>
</tbody>
</table>
Income Statement Classification

- **Discontinued Operations**
  - Shows income/loss related to major segments of the business that have been discontinued.

- **Extraordinary Items**
  - Defined by GAAP as a gain or loss that is both *unusual* in nature and *infrequent* in occurrence.

I hate it when a factory burns down!!!
Changes in Accounting Policies

- GAAP requires consistent application of principles from one period to the next.
- When a change in principle occurs, special accounting and reporting of the effect of the change is required.

Subsequent Events

- An event that occurred after the financial statement date that might influence a reader of the financial statements.
- If relates to conditions that existing at the financial statement date, the statements should be adjusted.
- If relates to conditions after the financial statement date, the event should be disclosed in a footnote.
End of Chapter 6

We’re cruisin’ now, dude!