TEAM PACIFIC CORPORATION

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REVENUE RECOGNITION

November 14, 2023

Reyes Tacandong & Co.
FIRM PRINCIPLES. WISE SOLUTIONS.

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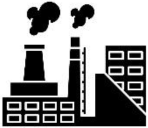
  

BASIC CONCEPTS

To recap…

Income

- Revenues
- Gains

Expenses

- Cost of services
- General and administrative expenses
- Losses

Revenue vs. Gains

Revenue

- Inflow of assets
- From normal business activities (e.g. sale of products)

Gains

- Inflow of assets
- From activities other than normal business activities (e.g. disposal of PPE)

Methods of Revenue Realization

Point of Sale	• Revenue recognized at the date when goods are delivered/services rendered
Point of Production	• Revenue recognized at the time of production
Percentage of Completion	• Revenue recognized in proportion to the progress or status of completion

Contra-Revenue Accounts

Sales Returns

Sales Discount

Sales Allowance

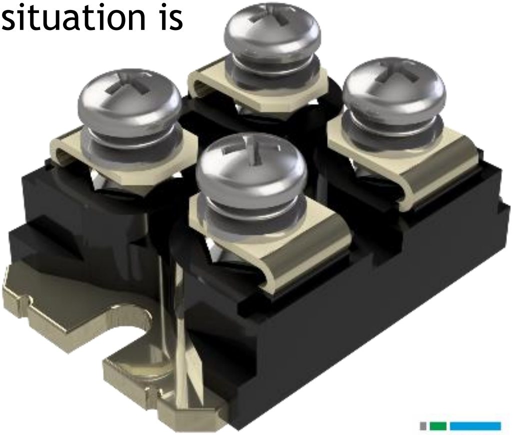
Understanding Sales Transactions

What is being given up?

What is being received?

What is being sold?

- often involve transfer of goods, services, or both
  (known as deliverables)
- accounting for each situation is different

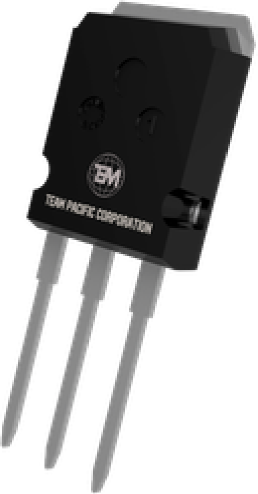


What is being sold?

Sale of goods: tangible assets with a finite point when control transfers to buyer (generally with transfer of legal title and possession)

Sale of services: legal title and possession irrelevant

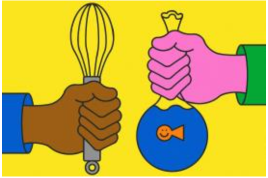
Sale of goods and/or services combinations: complexity in measuring each component of bundled sales or multiple deliverables



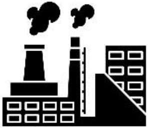
What is being received?

Cash or cash-like

Barter



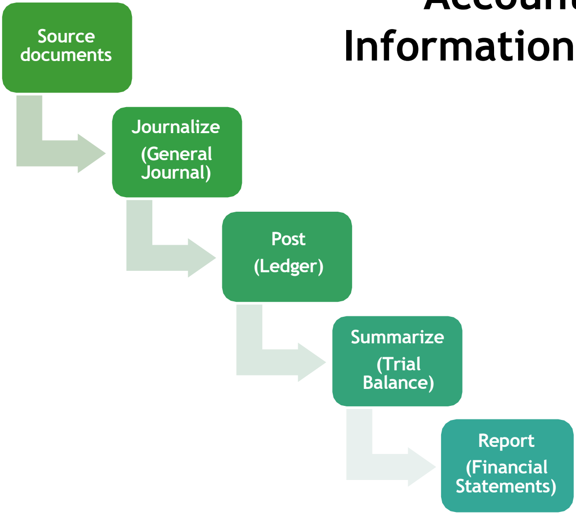
Value of deliverables sold = Value of consideration received

REVENUE AND COLLECTION CYCLE

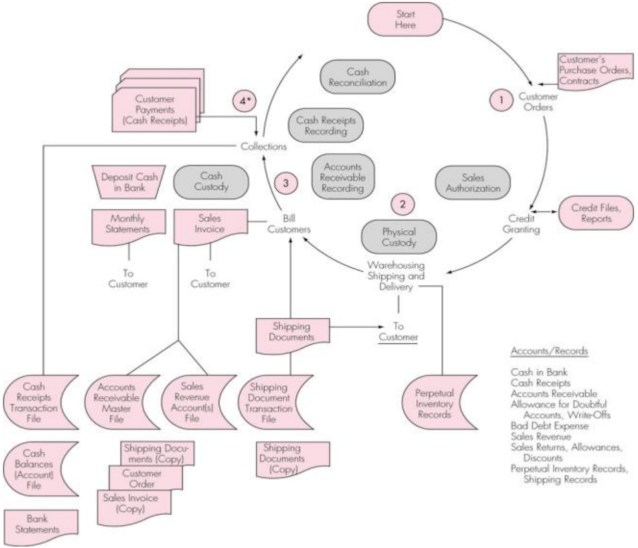
To recap…

Accounting Information System



Flow of Data

Revenue and Collection Cycle



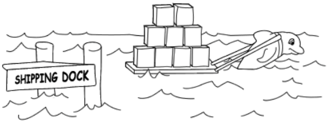
Customer Contract

- ❑ Contract creates enforceable obligations and establishes the terms of the deal
- ❑ Sales contract generally determines the point when legal title and possession of goods sold pass on to the customer:
  - FOB shipping point
  - FOB destination

Customer Contract

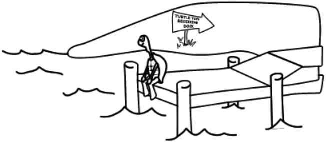
FOB shipping point v. FOB destination

FOB shipping point



Sale when shipped

FOB destination



Sale when arrives

Concessionary Terms

Lenient return/ payment policy

Selling price is deeply discounted

Continued involvement by the seller

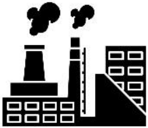
More accommodating credit policy

“Bill and hold” transactions

Inclusion of “extras”

These may create additional obligations or may indicate that control has not passed to the buyer.





REVENUE RECOGNITION

Revenue

Revenue

- Inflow of assets
- From normal business activities (e.g. sale of products)

Approaches in Recognizing Revenue

- Asset-Liability Approach
- Earnings Approach

Asset-Liability Approach

KEY OBJECTIVE

Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that the company receives, or expects to receive, in exchange for these goods or services.

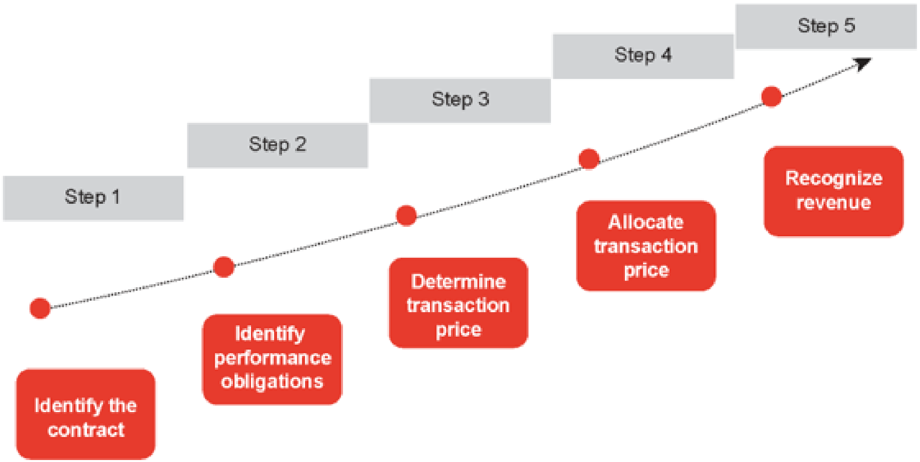
FIVE-STEP PROCESS FOR REVENUE RECOGNITION

1. Identify the contract with customers.
2. Identify the separate performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the separate performance obligations.
5. Recognize revenue when each performance obligation is satisfied.

REVENUE RECOGNITION PRINCIPLE

Recognize revenue in the accounting period when the performance obligation is satisfied.

Five-step Process



Five-step Process

Step 1: Identify the contract with customers. → A contract is an agreement between two parties that creates enforceable rights or obligations. In this case, Boeing has signed a contract to deliver airplanes to WestJet.

Step 2: Identify the separate performance obligations in the contract. → Boeing has only one performance obligation: to deliver airplanes to WestJet. If Boeing also agreed to maintain the planes, a separate performance obligation is recorded for this promise.

Step 3: Determine the transaction price. → Transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring a good or service. In this case, the transaction price is straightforward—it is $100 million.

Five-step Process

Identifying Separate Performance Obligations

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

Five-step Process

Step 1: Identify the contract with customers.	A contract is an agreement between two parties that creates enforceable rights or obligations. In this case, Boeing has signed a contract to deliver airplanes to WestJet.
Step 2: Identify the separate performance obligations in the contract.	Boeing has only one performance obligation: to deliver airplanes to WestJet. If Boeing also agreed to maintain the planes, a separate performance obligation is recorded for this promise.
Step 3: Determine the transaction price.	Transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring a good or service. In this case, the transaction price is straightforward—it is $100 million.

Five-step Process

Step 4: Allocate the transaction price to the separate performance obligations.

In this case, Boeing has only one performance obligation: to deliver airplanes to WestJet.

Step 5: Recognize revenue when each performance obligation is satisfied.

Boeing recognizes revenue of $100 million for the sale of airplanes to WestJet when it satisfies its performance obligation: the delivery of the airplanes to WestJet.

Five-step Process

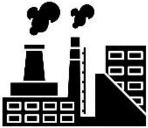
Recognizing Revenue when each Performance Obligation is Satisfied – Step 5

- A company satisfies its performance obligation when the customer **obtains control of the good** or service
- Indicators of control:
  - The company has a right to payment for the asset
  - The company has transferred the legal title to the asset
  - The company has transferred physical possession of the asset
  - The customer has significant risks and rewards of ownership
  - The customer has accepted the asset

Earnings Approach

Revenues for the sale of goods are recognized when the following criteria are met:

- Risks and rewards of ownership are transferred to the buyer
- Seller has no continuing involvement in, nor effective control over the sold goods
- Costs and revenues can be reliably measured; and
- Collectibility is probable



SPECIAL CONSIDERATIONS

Revenue Recognition Issues

Require **significant management judgment**.

Revenue Recognition Issues

Right of return

Repurchase agreements

Bill and Hold

Principal-agent relationships

Consignments

Warranties

Non-refundable upfront fees

Right of Return

If there is an expectation that items may be returned, an estimate must be made and accounted for the initial transaction.

RIGHT OF RETURN

Facts: Venden Company sells 100 products for $100 each to Amaya Inc. for cash. Venden allows Amaya to return any unused product within 30 days and receive a full refund. The cost of each product is $60. To determine the transaction price, Venden decides that the approach that is most predictive of the amount of consideration to which it will be entitled is the most likely amount. Using the most likely amount, Venden estimates that:

1. Three products will be returned.
2. The costs of recovering the products will be immaterial.
3. The returned products are expected to be resold at a profit.

***Question:* How should Venden record this sale?**

Right of Return

Solution: Upon transfer of control of the products, Venden recognizes (a) revenue of $9,700 ($100 × 97 products expected not to be returned), (b) a refund liability for $300 ($100 refund × 3 products expected to be returned), and (c) an asset of $180 ($60 × 3 products) for its right to recover products from customers on settling the refund liability. Hence, the amount recognized in cost of sales for 97 products is $5,820 ($60 × 97).

Venden records the sale as follows.

Cash	10,000	
Sales Revenue		9,700
Refund Liability		300

Venden also records the related cost of goods sold with the following entry.

Cost of Goods Sold	5,820	
Estimated Inventory Returns	180	
Inventory		6,000

When a return occurs, Venden should reduce the Refund Liability and Estimated Inventory Returns accounts. In addition, Venden recognizes the returned inventory in a Returned Inventory account as shown in the following entries for the return of two products.

Refund Liability (2 × $100)	200	
Accounts Payable		200
Returned Inventory (2 × $60)	120	
Estimated Inventory Returns		120

Repurchase Agreements

If a company enters into a repurchase agreement, it will allow them to transfer an asset to customer but have an **obligation or right to repurchase** the asset at a later date.

Raises the question, “did the company actually sell the asset?”

Bill-and-Hold Arrangements

A contract under which one entity bills a customer for a product but the **entity retains physical possession of the product until it is transferred to the customer** at a point in the future,

May occur when the purchasing company has limited available space for the product, delays in their production schedule, more than sufficient inventory in its distribution channel.

Principal-Agent Relationships

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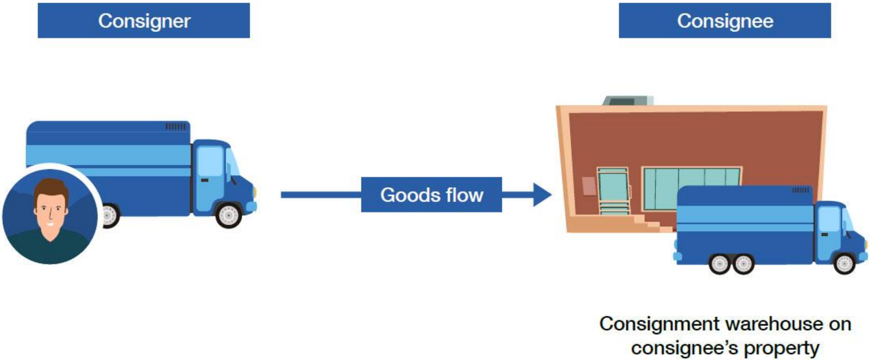
Consignment



Warranties

Warranties that the product **meets agreed-upon specifications in the contract at the time the product is sold**

- This type of warranty is included in the sales price of a company's product (assurance type warranty)

Warranties that **provide an additional service** beyond the assurance-type warranty

- This type of warrant is not included in the sales price of a company's product (service type warranty)

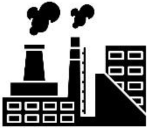
Non-refundable Upfront Fees

Companies receive payments (upfront fees) from customers before they deliver a product or perform a service.

Generally, relate to the initiation, activation or setup of a good or service to be provided or performed in the future.

In most cases the upfront payment is non- refundable.





PRESENTATION AND DISCLOSURE

Financial Statements Presentation

The disclosure requirements for revenue recognition are designed to help financial statement users understand the **nature**, **amount**, **timing** and **uncertainty of revenue and cash flows** arising from contracts with customers.

To achieve this, companies disclose quantitative and qualitative information about the following:

- Contracts with customers
- Significant judgements
- Assets recognized from costs incurred to fulfil a contract

Financial Statements Presentation

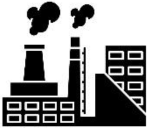
Contract assets and contract liabilities must be recorded on the balance sheet.

- There are **two types of contract assets**
  - Unconditional rights to receive consideration
  - Conditional rights to receive consideration

- A contract liability is a company's obligation to transfer goods or services to a customer for which the company has received consideration from the customer

If it is probable that the transaction price will not be collected, this is an indication that the parties are not committed to their obligations.

As long as a contract exists the amount recognized as revenue is not adjusted for customer credit risk.

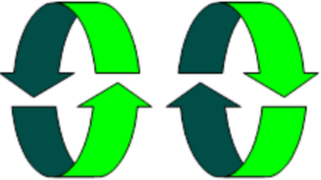
  

PROFITABILITY ANALYSIS

Receivables Turnover Ratio

$$\text{Receivables Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

Whenever a ratio divides an income statement balance by a balance sheet balance, the average for the year is used in the denominator.



This ratio measures how many times a company converts its receivables into cash each year.

Average Collection Period

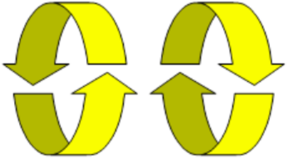
$$\text{Average Collection Period} = \frac{365}{\text{Receivables Turnover Ratio}}$$

This ratio is an approximation of the number of days the average accounts receivable balance is outstanding.

Inventory Turnover Ratio

$$\text{Inventory Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

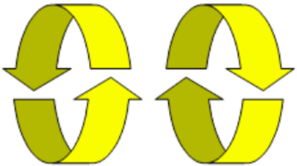
This ratio measures the number of times merchandise inventory is sold and replaced during the year.



Average Days in Inventory

$$\text{Average Days in Inventory} = \frac{365}{\text{Inventory Turnover Ratio}}$$

This ratio indicates the number of days it normally takes to sell inventory.



Asset Turnover Ratio

$$\text{Asset Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$

This ratio measures how efficiently a company utilizes all of its assets to generate revenue.

Profit Margin on Sales

$$\text{Profit Margin on Sales} = \frac{\text{Net Income}}{\text{Net Sales}}$$

This ratio indicates the portion of each dollar of revenue that is available to cover expenses.

Return on Total Assets

$$\text{Return on Total Assets} = \frac{\text{Net Income}}{\text{Average Total Assets}}$$

This ratio measures how well assets have been employed.

Return on Equity

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Average Shareholders' Equity}}$$

This ratio measures the ability of management to generate net income from the resources the owners provide.

Questions and answers?

THANK YOU FOR YOUR TIME AND ATTENTION.