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1 Introduction to Business Activities

1.1 Overview of Business Activities

1. Establish Goals and Strategies
   (a) Goals - the results toward which the firm directs its energies; maximizing returns
   (b) Strategies - the means for achieving those results; management determining the firm's line of business
   (c) Factors affecting goals and strategies
      i. Goals and strategies of competitors
      ii. Barriers to entry of industry
      iii. Nature of demand for firm's goods and services
      iv. Existence and nature of government regulation
2. Obtain Financing
   (a) Financing - Funds from owners and creditors
   (b) Publicly traded - Shares trade on active markets
   (c) Creditors - Provides funds that firm must repay over specific amount of time
      i. Long term - Period of time exceeding one year
      ii. Short term - Payment over the next year
   (d) Bond - Specifies amount borrowed and time of repayment
3. Make Investments
   (a) Land, Building, and Equipment - Provide capacity to sell/manufacture goods, typically long term
   (b) Patents, Licenses, and other Contractual Rights - Rights to use ideas, intangible
   (c) Common shares or bonds of other firms

(d) Inventories

(e) Accounts Receivable from Customer - Amount owed by customer for short periods of time

(f) Cash

4. Carry Out Operations

   (a) Purchasing

   (b) Production - Combining raw materials, labor services for to produce goods for sale

   (c) Marketing - Oversees selling and distribution

   (d) Administration - Data-processing, HR management, legal services

   (e) Research and Development

1.2 Principal Financial Statements

1. Annual Report to Shareholders - Describes firm's goals, strategies; if traded publicly, will file an annual report with a regulator, typically government agency

2. Management Discussion and Analysis (MD&A)

3. Financial Reporting Conventions

   (a) Length of Reporting Period

      i. Fiscal year

      ii. Calendar year

   (b) Number of Reporting Period

      i. GAAP and IFRS require firms to include results for multiple reporting periods in each report

      ii. Must include two balance sheets describing beginning and ending balances for current and prior fiscal year

   (c) Terminology and Level of Detail

      i. IFRS contains relatively more guidance

4. Balance Sheet - Statement of financial position

   (a) Concepts of Assets, Liabilities, and Shareholders' Equity

      i. Assets - economic resources with potential to provide future economic benefits to a firm

      ii. Liabilities - Creditors' claims

      iii. Shareholders' Equity - Amount of funds owners have provided either by buying share or by retained earnings; shareholders have a claim on assets that are in excess of assets required to meet creditors' claims

    iv. Retained Earnings - Net assets
    v. Accumulated Deficit - cumulative earnings less dividends are negative

(b) Balance Sheet Classification and Aggregation
    i. Both GAAP and IFRS require balance sheets separate current items from noncurrent items
    ii. Current assets - A firm expects to turn into cash/sell/consume with one year from the date of balance sheet
    iii. Current liabilities - Obligations a firm expects to pay within one year
    iv. Noncurrent assets - assets that will be used for several years
    v. Noncurrent liabilities and shareholders' equity - Sources of funds whose suppliers do not expect to receive payment within the next year

(c) Balance Sheet Measurement
    i. Both GAAP and IFRS use two bases to measure monetary amounts for assets/liabilities/S.E.
    ii. Historical Amount - Reflects acquisition cost of assets or the amount of funds originally obtained from creditors/owners
    iii. Current Amount - Measure of current value as of balance sheet date

5. Income Statement

    (a) Statement of profit and loss by firms applying IFRS
    (b) Revenues - Inflows of assets from selling goods and providing services to customers
    (c) Expenses - Measures outflow of assets incurred in generating revenues
        i. Cost of goods sold
        ii. Selling and administrative expenses
    (d)

6. Statement of Cash Flows

    (a) Reports information about cash generated from or used by
    (b) Operating Activities
    (c) Investing Activities - Acquisition of buildings, equipment, and other noncurrent assets to maintain or expand to their productive capacity; capital expenditures
    (d) Financing Activities - Obtain financing by issuing debt or common shares

7. Statement of Shareholders' Equity

    (a) Presents changes in shareholders' equity

1.3 Financial Reporting Process

1. Managers and Governing Boards of Reporting Entities
   (a) Managers - Agents of shareholders and have responsibility for safeguarding and properly using the firm's resources
   (b) Governing Board/Board of Directors - Responsible for selecting, compensating, and overseeing managers; for establishing dividend policy; making decisions on major issues
2. Accounting Standard Setters and Regulatory Bodies
   (a) U.S. GAAP
      i. Securities and Exchange Commission (SEC) - Agency of federal government with authority to establish accounting Standards; enforcement agency for U.S. securities laws
      ii. U.S. SEC Registrants - Firm incorporated in US that lists and trades its securities in US
      iii. Non U.S. SEC registrant - Foreign private issuers
      iv. Financial Accounting Standards Board (FASB) - SEC largely delegates take of financial standards; private with seven voting members
      v. Generally Accepted Accounting Principles (GAAP)
      vi. Conceptual Framework for FASB
         A. Objective of financial reporting
         B. Qualitative characteristics of accounting information - Relevance, Representational faithfulness, Comparability, Verifiability, Timeliness and understandability
         C. Elements of Financial Statements
         D. Recognition and Measurement Principles
   (b) International Financial Reporting Standards (IFRS)
      i. International Accounting Standards Board (IASB) - Independent Accounting standard-setting entity, currently 15 members
   (c) Independent Auditors
      i. Audit
         A. Assessment of capability of a firm's accounting system to accumulate, measure, and synthesize transactional data
         B. Assessment of operational effectiveness of accounting system
         C. Determination of whether financial report complies with requirements of applicable authoritative guidance
      ii. Audit Opinion - auditor's conclusions
      iii. Sarbanes-Oxley Act - Established Public Company Accounting Oversight Board (PCAOB)
   (d) Users of Financial Statements

1.4 Basic Accounting Conventions and Concepts

1. Realization - Converting a noncash item to cash
2. Materiality - Financial reports need not include items so small as to be meaningless to users
3. Accounting Period Convention - Length of Financial reporting periods
4. Accounting/Reporting Period
5. Interim Report - Periods shorter than a year; does not eliminate the need to prepare an annual report

1.5 Accounting Methods for Measuring Performance

1. Cash Basis of Accounting - Firm measures performance from selling goods and services as it receives cash from customers and makes cash expenditures
   (a) Cash basis does not match cost of efforts required to generate inflows with inflows themselves
   (b) Cash Basis separates recognition of revenue from process of earning those revenues
   (c) Performance measured using cash basis is sensitive to the timing of cash expenditures
2. Accrual Basis of Accounting - Recognizes revenue when a firm sells goods or renders services
   (a) Provides a measure of performance for future periods because activities of future periods will bear share of costs of rent and other services the firm will consume
   (b) Matching Convention - Matches expenses with their related revenues by subtracting their amount in measuring performances

2 Balance Sheet

2.1 Accounts

1. Permanent Accounts - Remain open with nonzero balances at end of reporting period (Balance sheet)
2. Temporary Account - Start a period with a zero balance, accumulate information during period, and end with zero balance (Income statement)

2.2 Balance Sheet

1. Common Terminology

   (a) Typical Asset Accounts

      i. Cash
      ii. Marketable Securities
      iii. Accounts, Notes, Interest Receivable
      iv. Inventory
      v. Advances to Suppliers
      vi. Prepaid Rent, Insurance
      vii. Investments in Securities
      viii. Property, Plant, Equipment
      ix. Accumulated Depreciation
      x. Patents, Goodwill

   (b) Typical Liability Accounts

      i. Accounts, Notes, Interest, Income Taxes Payable
      ii. Advances from Customers
      iii. Mortgage, Bonds Payable
      iv. Deferred Income Taxes

   (c) Typical Shareholders' Equity Accounts

      i. Common Stock (at par)
      ii. Additional Paid-In Capital
      iii. Preferred Stock
      iv. Retained Earnings
      v. Accumulated Other Comprehensive Income

2.3 Typical Balance Sheet

1. Current vs Non-Current
2. GAAP - Assets and liabilities appear in order of decreasing closeness to cash (least liquid to most)
3. IFRS - Reversed

2.4 Dual Effect of Transactions

1. Balance Sheet Equation - Assets = Liabilities + Shareholder's Equity
2. Dual Effect of Transactions

2.5 T-Accounts

1. Device for organizing and accumulating accounting entries of transactions that affect an individual account (ex: cash, accounts receivable)
2. Debit is on left side
3. Credit is on right side
4. Assets on left side, liabilities and S.E. are on right
5. Increases in an account occur on same side, decreases on opposite

2.6 Journal Entries

1. Standard format to indicate the accounts and amounts affected by each transaction
2. Posting - Accountant should transfer amounts from journal entry to appropriate T-account

3 Income Statement

3.1 Income Statement

1. Common Terminology
   (a) Revenues or Sales
   (b) Cost of Goods Sold
   (c) = Gross Profit
   (d) Selling, General, and Administrative (costs)
   (e) Research and Development (R&D)
   (f) = Operating Profit
   (g) Interest Expense
   (h) Interest Income
   (i) Income Tax Expense
   (j) = Net Income

3.2 Relation between Balance and Income

1. Beginning balance of shareholders' equity account Retained Earnings + net income of income statement - dividends = Ending Retained Earnings
2. Calculation of net income is not purpose of income statement; rather, to display line items for components of net income, company performance

3. Closing - Transferring all non-zero balances of temporary accounts to permanent accounts (Transferring revenue and expenses to retained earnings = income to balance)
4. Would be the same as transferring directly to Retained Earnings every time, separate makes easier

3.3 Accounting Process for Revenues, Expenses, and Dividends

3.4 Adjusting Entries

1. Contra Account - Account that accumulates subtractions from another account (accumulated depreciation)
2. Correcting Entries - Adjusting entries correct recording errors that firm detects at end of period
3. Typical Adjusting Entries
   (a) Unearned Revenues
   (b) Accrued Revenues
   (c) Prepaid Expenses
   (d) Accrued Expenses
4. Cash is NOT an adjusting entry

3.5 Financial Statement Preparation

1. Preparation of Income Statement
   (a) Parentheses indicate numbers to be subtracted
   (b) Neither GAAP nor IFRS defines operating income/profit, although both often appear on income statements
2. Closing Entries
   (a) Closing process - Reducing to zero balance in each income statement and debiting/crediting Retained Earnings
3. Preparation of Balance Sheet
   (a) After closing, accounts with nonzero balances are all balance sheet accounts
4. Preparation of Cash Flows
   (a) Direct Method - Lists sources of cash from operating activities
   (b) Indirect Method - Reconciles net income to cash flows from operations by adjusting net income for noncash income statement components

4 Balance Sheet - Presenting and Analyzing Resources and Financing

4.1 Underlying Concepts

1. Balance Sheet Equality
2. Balance Sheet Classifications
   (a) Current Assets - Expected to realize during the operating cycle

4.2 Asset Recognition and Measurement

1. Asset Definition and Recognition
   (a) Probable future economic benefit
   (b) Recognition
      i. Firm owns or controls the right to use the item
      ii. Right to use the item arises as a result of a past transaction or exchange
      iii. Future benefit has a relevant measurement attribute that can be quantified with sufficient reliability
   (c) Reliability - Amount corresponds to what it purports to represent
2. Asset Measurement
   (a) Acquisition (historical) Cost - Amount of cash paid to acquire an asset
   (b) Current replacement cost - asset is the amount a firm would have to pay to obtain another asset with identical service potential; which is an entry value, reflecting economic conditions at measurement date
   (c) Net Realizable Value - Net cash firm would receive if it sold asset
   (d) Fair value - Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at measurement date
   (e) Present Value of Future Net Cash Flows - Sum of present values of the individual future cash inflows and outflows associated with an asset
3. Measurement Approaches for Specific Assets
   (a) GAAP and IFRS specify asset measurement basis for financial reporting
   (b) Financial Assets - Cash and claims to cash
   (c) Nonfinancial Assets - Tangible and intangible resources firms uses in operations to generate future cash flows
   (d) Impairment - Asset's fair value falls below its carrying value

4.3 Three Conventions Underlying Asset Measurement

1. Going Concern
   (a) Realize changes in fair values of assets by using assets or selling them
   (b) Value Decreases - Impairment losses
   (c) Value Increases - GAAP forbids the recognition of unrealized gains from increases in the fair value of most nonfinancial assets
2. Relevance and Reliability
   (a) Relevance - Information could affect decisions of users of financial reports
   (b) Reliability - Information presented is reasonably free from error and bias
3. Conservatism
   (a) Possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets

4.4 Liability Recognition and Measurement

1. Liability Definition and Recognition
   (a) Probable future sacrifices of economic benefits arising from present obligations to transfer assets in future as a result of past event/transaction
   (b) Recognition
      i. Item represents a present obligation, not potential future commitment or intent
      ii. Obligation must exist as a result of a past transaction - obligating event
      iii. Obligation must require a probable future economic resource that firm has little or no discretion to avoid
      iv. Obligation has relevant measurement base that firm can quantify
   (c) Mutually Unexecuted Contract (executory)
2. Liability Measurement

4.5 Shareholders' Equity Measurement and Disclosure

1. Additional paid-in Capital (APIC)
2. par value stuff we havent talked about

5 Income Statement: Reporting the Results of Operating Activities

5.1 Reporting Expenses

1. Gross Profit - Revenue - COGS
2. Operating Expenses
3. Operating Profit - Neither GAAP nor IFRS requires
4. Income from continuing/discontinued operations - GAAP and IFRS requires separation

5.2 Revenue Recognition and Measurement

1. Revenue Recognition
   (a) Timing and measurement of revenues
   (b) Misreporting revenue is a common form of accounting fraud
   (c) Firms bundle products and services and sell in multiple-element arrangements
   (d) Distinguish revenue from gains, expenses from losses

5.3 Expense Recognition and Measurement

1. Timing of Expense Recognition - When firm consumes benefits
2. Criteria for Expense Recognition
   (a) Consumption of asset results from a transaction that leads to the recognition of revenue
   (b) Consumption of asset results from passage of time
3. Recognition of Product Costs
4. Recognition of Period Expenses
5. Expense Measurement

5.4 Comprehensive Income

1. Other Comprehensive Income (OCI) - GAAP and IFRS require firms to change carrying value of certain assets
2. Net Income + OCI = Comprehensive Income
3. Accumulated Other Comprehensive Income (AOCI) - GAAP and IFRS require firms to report cumulative effect of OCI in a balance sheet account

6 Statement of Cash Flows

6.1 Need for a Statement of Cash Flows

1. Net income for a particular period does not equal cash flow from operations
   (a) Because firms use accrual basis, income does not equal cash flow for a given period
   (b) Revenue Recognition - Firms typically recognize revenue at the time of sale, regardless of when the receive cash from sale
   (c) Expense Recognition - Firms recognize expenses either in the period when the recognize associated revenues or in the period when they consume materials/services used in operations
2. Firms receive cash inflows and disburse cash outflows because of investing and financing activities
   (a) Income statement does not report many of a firm's investing and financing inflows/outflows directly
   (b) Examples
      i. Firms use cash to acquire PP&E; initial capitalization of expenditures during period of acquisition, later costs of depreciation
      ii. Debt service payments require cash; principal payments not on income statement, however interest is
3. Difference
   (a) Balance Sheet - Report balance in cash account at beginning end, doesn't explain why it has changed
   (b) Income Statement - Reports increase/decrease in net assets from selling goods and providing services
   (c) Accrual Accounting - Increase in net assets when firm earns income, however increase isn't always cash
   (d) Cash Flows - Helps reader understand how a firm obtains and uses cash

6.2 Overview

1. Statement Explains the Reasons for Change in Cash between Balance Sheet Dates
   (a) GAAP and IFRS require cash flows explains change in cash and cash equivalents
   (b) Cash equivalents- Short-term, highly liquid investments in which a firm has temporarily placed excess cash

2. Statement Classifies Reasons for Change in Cash as Operating/Investing/Financing Activity

    (a) Operations - Amount of cash flow from operations indicates extent operating activities generate more cash than they use

    (b) Investing - Acquisition of noncurrent assets (PP&E) usually represent a major ongoing use of cash; must eventually replace assets, usually comes from cash flow from operations

    (c) Financing - Uses cash to pay dividends to shareholders, repay borrowing, reacquire outstanding shares of stock; gets cash from issuing stock

    (d) Ambiguity in Classifying Cash Flows

        i. Cash receipts from interest and dividends is an operating activity

        ii. Cash flows related to purchase and sale of investments in securities is an investing activity

3. Reading and Interpreting Info in Cash Flows

    (a) Free Cash Flow - Excess of cash flow from operations over cash flow from investing

    (b) Free cash flow uses for repay borrowing, dividends, add cash to balance sheet

4. Presentation Formats for Cash Flows

    (a) Must report cash flows for current year and prior two years

    (b) Must report begin/end/change in cash balance, and reconcile change in cash with operating/investing/financing

    (c) Firm show gross cash inflows and outflows; separate cash spent on acquisition separately from amount of cash received from assets

    (d) Nonmonetary/non-cash transactions are not recorded; such as equipment for shares

5. Cash Flows Reconciles Net Income with Cash Flow from Operations

    (a) Direct Method - Amounts of cash received from customers less cash disbursed to suppliers, employees, lenders, tax

    (b) Indirect Method - Net income for a period and presents adjustments to net income for revenues/expenses not matched with cash receipts

6.3 Preparing Statement of Cash Flows

1. Cash Change Equation

    (a) Change in Cash = Change in Operating/Financing/Investing - Change in Non-Cash Assets

2. Indirect vs Direct
   (a) Indirect - Net income (revenue - expenses); then adjusted for revenues or expenses that produce/use cash in amounts different from the revenue or expense item
   (b) Direct - Lists each revenue amount that increases cash and each expense amount that reduces cash

6.4 Using Information from Statement of Cash Flows

1. Increased earnings do not always generate increased cash flow from operations
2. Growing/Successful firm may have increasing amounts of accounts receivable, which means a lag between earnings and cash flows, ultimately could have negative cash from operations

6.5 Interpretative Issues Involving Cash Flows

1. Timing of Operating Cash Flows
   (a) Firms have choice as to when to disburse cash; holding off on payments from one period to next increases cash for current period

7 Financial Statement Analysis

8 Revenue Recognition, Receivables, and Advances from Customers

8.1 Review and Application of Income Recognition

1. Revenue Recognition
   (a) "Earned" Condition - Seller must have substantially performed its obligations to the customer, such as transferring ownership
   (b) "Realized" Condition - Seller must have obtained asset from customer that it can reliably measure; if asset is noncash, must be reasonably certain of converting it to cash
2. Revenue Recognition by SEC
   (a) Persuasive evidence of an arrangement exists
   (b) Delivery has occurred or services have been performed
   (c) Seller's price to buyer is fixed or determinable
   (d) Collectibility is reasonably assured

3. Expense Recognition
   (a) Recognize when asset is consumed
   (b) If event/transaction leads to recognition of revenue, firms match consumption of assets, in time, with revenue recognized

8.2 Application of Income Recognition Principles

1. Later in Chapter
   (a) Customers' promises to pay cash later (account receivables)
   (b) Arrangements when collectibility is highly uncertain - requires seller recognize revenue as cash it received
   (c) Customers' cash payments to seller before seller delivers g/s (accounts payable)
   (d) Customers' rights to return goods
   (e) Contracts that contain several components, arrangements with multiple deliverables
   (f) Long-term contracts, using percentage-of-completion method and completed contract method

8.3 Income Recognition at Time of Sale

1. Accounts Receivable
   (a) Also known as trade receivable - Amount on seller's balance sheet owed by customers who have purchased g/s on credit
   (b) Uncollectible account - Account receivable that seller never collects; typically more sales while having uncollectible accounts, even though they are unfavorable
2. Allowance Method for Uncollectible Accounts
   (a) Issues with accounting issues for account receivables
      i. Measurement of amount of balance sheet
      ii. Timing of recognition of the reduction in income caused by uncollectibility of some accounts
   (b) Authoritative guidance requires that sellers report accounts receivable net of the estimated uncollectible amount
   (c) Authoritative guidance requires allowance method for uncollectible accounts
      i. Involves estimating amount of uncollectible accounts receivable associated with credit scales

ii. Estimated amount is recognized as an adjusting entry at end of each period
iii. Credit is to a contra-asset account; Allowance for Uncollectibles
iv. Account Receivables Net = Accounts Receivable Gross net Allowance for Uncollectibles

(d) Bad Debt Expense / Provision for Bad Debts/Uncollectible Accounts - How firms list reduction in income

(e) Contra-asset account typically has credit balance

(f) Accounts Receivable, Gross - Firm keeps a separate account for each customer; sum of balances in individuals' accounts is balance

(g) Control Account - Aggregate of like accounts

(h) Writing off - Firm determines a particular customer accounts is uncollectible

3. Procedural Note on the Allowance Method

   (a) Firms typically write off specific customers' accounts during reporting period

   (b) Firms typically recognize bad debt expense as an adjusting entry at end of period

      i. Before Adjusting entry is made, firm may have debit balance in Allowance for Uncollectibles
      ii. After adjusting entry is made, Allowance for Uncollectibles always has a credit balance

4. Estimating Amount of Uncollectible Accounts

   (a) GAAP and IFRS does not require firms to use one or other

5. Percentage-of-Sales Procedure

   (a) Idea that uncollectible amounts will vary with volume of credit sales

6. Aging-Of-Accounts-Receivable Procedure

   (a) Estimating the amount the firm does not expect to collect from existing accounts receivable

   (b) Adjusting the balance in Allowance for Uncollectibles so Gross Accounts Receivable - Allowance for Uncollectibles, reflects amount of cash firm expects to collect

7. Comparing Percentage-of-Sales and Aging Procedures

   (a) Percentage-of-sales

      i. Firm estimates Bad Debt Expense

    ii. Uses Bad Debt Expense, beginning balance Allowance for Uncollectibles, and write-offs to calculate ending balance in Allowance for Uncollectibles
    iii.

8. Dealing with Changes in Estimates of Uncollectible Accounts
    (a) Differences between estimated and actual uncollectible amounts
        i. Changes in economic conditions
        ii. Changes in credit-granting policies
        iii. Changes in collection efforts
    (b) GAAP and IFRS require firms to reflect changes in estimates prospectively; no retroactive adjustment to income statements and balance sheets of previous periods to reflect differences
    (c) Firm adjusts balance in Allowance for Uncollectibles going forward
9. Summary for Allowance Method of Uncollectible Accounts
    (a) Gross Accounts Receivable vs Sales Revenue
    (b) Cash vs Gross Accounts Receivable
    (c) Bad Debt Expense vs Allowance for Uncollectibles
    (d) Allowance for Uncollectibles vs Gross Accounts Receivable
10. Analyzing Accounts Receivable
    (a) Financial Statement Presentation
        i. Accounts Receivable appear on balance sheet at amount firm expects to collect
    (b) Financial Ratios Involving Accounts Receivable (Chapter 7 Stuff)
        i. Accounts Receivable Turnover Ratio
        ii. Days Receivables Outstanding
    (c) Transfer of Accounts Receivable in Exchange for Cash
        i. Use accounts receivable as collateral for a loan
            A. Firm will continue to show receivables as an asset, and there will also be a loan payable liability
        ii. Factor (sell) its accounts receivable to a bank or other financial institution in exchange; lender controls receivables and collects cash
        iii. Securitization - firm may transfer accounts receivables to a legally separate entity that issues debt securities to investors
11. Sales Returns: Application of the Allowance Method

(a) Accountants use allowance method when, at time of sale, they can estimate with reasonable reliability the effects of events that will affect future cash flows

(b) GAAP and IFRS require firms use the allowance method to estimate and recognize the effects of returns

(c) Sales Returns - Revenue contra accounts

(d) Allowance for Sales Returns - Contra account to Gross Accounts Receivables

8.4 Income Recognition after the Sale

1. Conditions for revenue recognition

    (a) Seller must have substantially performed its obligations to the customer

    (b) Seller must have obtained an asset from customer that it can reliably measure. If non cash asset, seller must be reasonably certain of converting asset into cash

2. Substantial Performance Remains

    (a) Deferred Performance Obligations - Advances from Customers

3. Substantial Uncertainty about Cash Collections Remains

    (a) Methods when seller cannot reliably estimate timing and amounts of cash it will collect; ex: franchise arrangement

    (b) Installment Method

        i. Recognizes revenue as the seller collects cash from customer

        ii. Assumes seller will receive all promised cash

        iii. Seller applies gross margin percentage on transaction to calculate the portion of total gross margin recognized in each accounting period

            A. Gross margin equals sales revenue minus COGS

            B. Gross margin percentage = gross margin / sales revenue

    (c) Cost Recovery Method

        i. Matches cost of generating revenue with cash receipts until the seller recovers all costs

        ii. Assumes cash collection is highly unlikely

        iii. Seller makes same journal entry at time of sale under cost recovery as installment method

        iv. Difference arises later when customer makes installment payments

    (d) Installment vs Cost Recovery

i. Installment reports income sooner than cost recovery
ii. Pattern holds independent of whether customer makes all promised payments
iii. GAAP permission for firms to use installment or cost recovery only when
   A. Receivables are collectible over an extended period
   B. Seller has no reasonable basis for estimating the amount of cash it will collect
iv. IFRS general guidance implies a qualitatively similar criterion, however not same level of detail

8.5 Income Recognition before Delivery

1. Long Term Contracts Characteristics
   (a) Period of construction spans several accounting periods
   (b) Seller identifies customer, agrees on contract price in advance, and has little doubt about the ability of customer to make agreed-on payments
   (c) Progress payments - Periodic payments of contract price as work progresses
2. Long-term Contracts Meeting Revenue Recognition
   (a) Existence of an arrangement that specifies a buyer, product to be delivered, and an agreed-on price
   (b) Seller reasonably expects the customer will pay the contract price in cash as construction progresses or when the seller completes the work
   (c) Seller can reliably estimate the costs it will incur in providing these future services
   (d) If arrangement meets these criteria, GAAP and IFRS require firms to recognize income using percentage-of-completion method
   (e) Otherwise, GAAP requires firm to recognize income using completed contract method
   (f) IFRS does not permit completed contract method and instead specifies a variant of cost recovery method
3. Percentage-Of-Completion Method
   (a) Recognizes a portion of the contract price as revenue during each period of construction or production
   (b) Portion of revenue recognized is based on proportion of total work performed during the period

(c) Usually use ratio of costs incurred to date to total estimated contract costs

(d) Construction in Progress/Process - Inventory account

(e) As firm recognizes revenue for portions of contract price, it also recognizes equal portions of total estimated contract cost as expenses by debiting COGS and crediting Construction in Progress

(f) Schedule of cash collections (progress payments) does not affect revenue recognition

(g) Even if contract specifies that customer will pay entire contract price upon delivery, seller may use percentage-of-completion so long as seller can reliably estimate amount of cash it will receive and expected costs

4. Completed Contract Method

   (a) Postpones revenue recognition until seller completes all construction or production and transfers the finished item to the customer

   (b) Applies to long-term construction contracts

   (c) GAAP specifies the completed contract method when outcome of contract is in doubt because of a lack of reliable estimate (costs or cash to be collected)

5. Percentage-of-Completion vs Completed Contract

   (a) Percentage-of-Completion provides information about seller's performance during the contract period

   (b) Completed Contract reports all profit only when seller completes contract

   (c) Percentage-of-Completion reflects current performance on a more timely basis

   (d) Firms would use completed contract if there is no contract with a specific customer

   (e) If there is sufficient uncertainty about total contract costs, seller may not use percentage-of-completion method

6. IFRS Requirements for Recognizing Contract Revenue when the Seller Cannot Reliably Estimate the Outcome

   (a) If seller cannot reliably estimate costs/revenue, IFRS requires seller recognize revenues equal to recoverable costs incurred and expensed