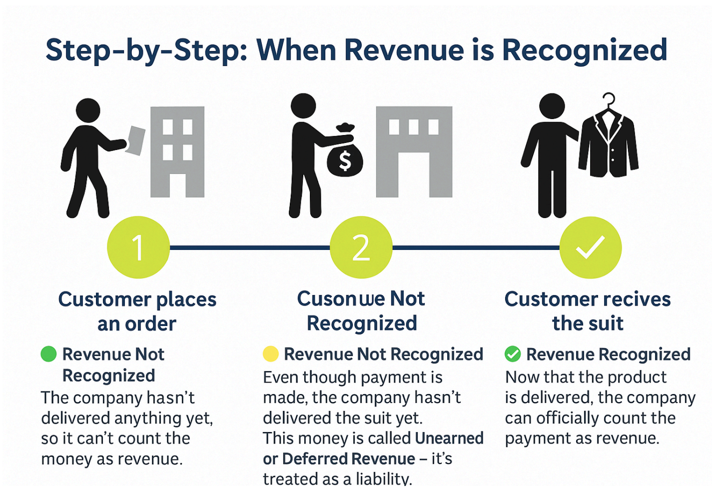
Revenue Principle

Understanding financial statements *requires significant consideration about how various valuations are calculated.* Reading between the lines and being aware of *both recognised and unrecognised revenues, assets, and liabilities* can help make informed judgements about the financial health of an organisation.

The four criteria or conditions need to be met for revenues to be recognised on the income statement. These criteria are referred to as the ***revenue principle:***

1. Delivery has occurred or the services have been rendered.
2. There is strong evidence of an arrangement for customer payment.
3. The price for the product or service provided is fixed or can be determined.
4. The collection of cash from the customer is reasonably assured. This is not an issue for cash sales since cash is received on the date of the exchange. For sales on credit, the company needs to review the customer's ability to pay.



Revenue is recorded on the income statement when the four conditions above are met, regardless of when cash is received by the firm from its customers.

Cash may be received before, during or after the revenue is earned.Companies usually need to explain, in the notes to the income statement, the revenue recognition policies they have applied.

Asset Recognition

Just like revenue is recognized on the income statement when it's earned, a similar principle applies to assets. Assets are considered resources that can provide future economic benefits to a business. In accounting, an item is recognized as an asset only if it meets two key conditions:

Ownership of Probable Future Economic Benefits
The business must have control over the resource, and there should be strong evidence that it will bring future benefits.

Reliable Measurement
The value of the asset must be measurable with reasonable accuracy and reliability. Only when both conditions are satisfied is the asset recorded on the balance sheet.

To recognize something as an asset, a firm must assess **how likely it is to receive future benefits** and whether those benefits can be **measured reliably**.For example, purchasing equipment meets both conditions—it will be used in operations to generate revenue, and the expected benefits can be measured. On the other hand, research expenses are uncertain. There's no guarantee of success, and the benefits can't be reliably measured. That's why such costs are not treated as assets on the balance sheet.

Categorising liabilities

The main types of liabilities are short-term and long-term. These can broadly be categorised as:

- ➔ ***Short-term liabilities are accounts payable.*** Generally, firms pay suppliers within 90 days. Also, many account terms are up to 30 days. If the firm receives a bill from a utility company it will typically have up to 30 days to pay the bill. So that's the sort of thing that is a short-term liability
- ➔ ***Long-term liabilities*** are expected to be paid over periods longer than one year. For instance, a business might get a 5-year loan from a bank, which means that it might have to pay the principal back in five years' time. That's more than a year so it's a long-term liability

Provisions are not about when the money is due. They are a kind of obligation that has come up because of a past event but the amount of money to be paid, and when that money has to be paid, are both uncertain.

A good example would be a lawsuit. A company could have provisions for an ongoing legal situation. Think about Volkswagen: having all those cars fitted with the wrong software led to litigation from customers and regulators. They need to think about the economic consequences not only of the recalls, and more which can cause provisions in their own right but also about the litigation they go through. Given that lawsuits take time, the firm does not know exactly when the damages will have to be paid or how much it will be required to pay.

Reflection: Factoring in such considerations around revenue, assets, and liabilities will help understand an organisation's financial situation. Monitoring and analysing how the ***organisation's financial statements change*** annually will help support in constructing an overview of where things may be going amiss.