FINANCIAL ACCOUNTING: FOUNDATIONS

OKTAY URCAN

Fundamental Accounting Concepts and Revenue Recognition

Overview

OVERVIEW

- Fundamental accounting concepts
- Accrual accounting revisited
- Revenue recognition

FINANCIAL ACCOUNTING: FOUNDATIONS

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Fundamental Accounting Concepts

FUNDAMENTAL ACCOUNTING CONCEPTS

- Going concern
- Conservatism
- Matching
- Consistency
- Accruals

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Accruals Concept

ACCRUALS

- Cash collection comes *after* revenues are earned.
- Cash payment comes *after* expenses are incurred.

ACCRUED REVENUE: EXAMPLE

A firm provides a service and earns $500 in November 2016 which is payable in April 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR				IS	RE

ACCRUED REVENUE: EXAMPLE

A firm provides a service and earns $500 in November 2016 which is payable in April 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR				IS	RE
Income earned		500				500	

ACCRUED REVENUE: EXAMPLE

A firm provides a service and earns $500 in November 2016 which is payable in April 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR				IS	RE
Income earned Transfer to RE		500				500 (500)	 500

ACCRUED REVENUE: EXAMPLE

A firm provides a service and earns $500 in November 2016 which is payable in April 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR				IS	RE
Income earned Transfer to RE		500				500 (500)	 500
Closing Balance		500					500

ACCRUED REVENUE: EXAMPLE

The firm receives $500 in April 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR				IS	RE
Opening balance		500					500

ACCRUED REVENUE: EXAMPLE

The firm receives $500 in April 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR				IS	RE
Opening balance Cash collection	 500	500 (500)					500

ACCRUED REVENUE: EXAMPLE

The firm receives $500 in April 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR				IS	RE
Opening balance Cash collection	 500	500 (500)					500
Closing Balance	500						500

ACCRUED LIABILITY: EXAMPLE

A firm receives a utility bill of $250 in December 2016 which is payable in January 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Utility Payable		IS	RE

ACCRUED LIABILITY: EXAMPLE

A firm receives a utility bill of $250 in December 2016 which is payable in January 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Utility Payable		IS	RE
Utility bill				250		(250)	

ACCRUED LIABILITY: EXAMPLE

A firm receives a utility bill of $250 in December 2016 which is payable in January 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Utility Payable		IS	RE
Utility bill Transfer to RE				250		(250) 250	 (250)

ACCRUED LIABILITY: EXAMPLE

A firm receives a utility bill of $250 in December 2016 which is payable in January 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Utility Payable		IS	RE
Utility bill Transfer to RE				250		(250) 250	 (250)
Closing Balance				250			(250)

ACCRUED LIABILITY: EXAMPLE

The firm pays the utility bill of $250 in January 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Utility Payable		IS	RE

ACCRUED LIABILITY: EXAMPLE

The firm pays the utility bill of $250 in January 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Utility Payable		IS	RE
Opening balance				250			(250)

ACCRUED LIABILITY: EXAMPLE

The firm pays the utility bill of $250 in January 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Utility Payable		IS	RE
Opening balance Bill payment	 (250)			250 (250)			(250)

ACCRUED LIABILITY: EXAMPLE

The firm pays the utility bill of $250 in January 2017.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Utility Payable		IS	RE
Opening balance Bill payment	 (250)			250 (250)			(250)
Closing Balance	(250)						(250)

DEFERRALS

Cash collection comes *before* revenues are earned.

Cash payment comes *before* expenses are incurred.

DEFERRED REVENUE: EXAMPLE

A firm receives $1,000 in October 2016 as an advance payment for a job to be delivered in December 2016.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Unearned Revenue		IS	RE

DEFERRED REVENUE: EXAMPLE

A firm receives $1,000 in October 2016 as an advance payment for a job to be delivered in December 2016.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Unearned Revenue		IS	RE
Advance payment	1,000			1,000			

DEFERRED REVENUE: EXAMPLE

A firm receives $1,000 in October 2016 as an advance payment for a job to be delivered in December 2016.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Unearned Revenue		IS	RE
Advance payment	1,000			1,000			
Job completed				(1,000)		1,000	

DEFERRED REVENUE: EXAMPLE

A firm receives $1,000 in October 2016 as an advance payment for a job to be delivered in December 2016.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Unearned Revenue		IS	RE
Advance payment Job completed Transfer to RE	1,000			1,000 (1,000)		1,000 (1,000)	1,000

DEFERRED REVENUE: EXAMPLE

A firm receives $1,000 in October 2016 as an advance payment for a job to be delivered in December 2016.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Unearned Revenue		IS	RE
Advance payment	1,000			1,000			
Job completed				(1,000)		1,000	
Transfer to RE						(1,000)	1,000
Closing Balance	1,000						1,000

PREPAYMENT: EXAMPLE

A firm pays $1,500 in January 2016 as an advance payment for next two years' rent.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	Prepaid Rent				IS	RE

PREPAYMENT: EXAMPLE

A firm pays $1,500 in January 2016 as an advance payment for next two years' rent.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	Prepaid Rent				IS	RE
Advance payment	(1,500)	1,500					

PREPAYMENT: EXAMPLE

A firm pays $1,500 in January 2016 as an advance payment for next two years' rent.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	Prepaid Rent				IS	RE
Advance payment Year 1 rent	(1,500)	1,500 (750)				 (750)	

PREPAYMENT: EXAMPLE

A firm pays $1,500 in January 2016 as an advance payment for next two years' rent.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	Prepaid Rent				IS	RE
Advance payment Year 1rent Transfer to RE	(1,500)	1,500 (750)				 (750) 750	 (750)

PREPAYMENT: EXAMPLE

A firm pays $1,500 in January 2016 as an advance payment for next two years' rent.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	Prepaid Rent				IS	RE
Advance payment Year 1rent Transfer to RE	(1,500)	1,500 (750)				 (750) 750	 (750)
Closing Balance	(1,500)	750					(750)

ACCRUALS CONCEPT: WALMART

Check Walmart's 2015 balance sheet to identify accruals and deferrals.

WALMART'S ASSETS 2015

Consolidated Balance sheets

(Amount in millions)	As of January 31 **2015**	2014
Assets		
Current assets:		
Cash and cash equivalents	**$ 9,135**	$ 7,281
Receivables, net	**6,778**	6,677
Inventories	**45,141**	44,858
Prepaid expenses and other	**2,224**	1,909
Current assets of discontinued operations	**---**	460
Total current assets	**63,278**	61,185
Property and equipment:		
Property and equipment	**177,395**	173,089
Less accumulated depreciation	**(63,115)**	(57,725)
Property and equipment, net	**114,280**	115,364
Property under capital leases:		
Property under capital leases	**5,239**	5,589
Less accumulated amortization	**(2864)**	(3,046)
Property under capital leases, net	**2,375**	2,543
Goodwill	**18,102**	19,510
Other assets and deferred charges	**5,671**	6,149
Total assets	**$203,706**	$204,751

WALMART'S LIABILITIES 2015

LIABILITIES, REDEEMABLE NONCONTROLLING INTEREST, AND EQUITY

Current liabilities:		
Short-term borrowings	**$ 1,592**	$ 7,670
Accounts payable	**38,410**	37,415
Accrued liabilities	**19,152**	18,793
Accrued income taxes	**1,021**	966
Long-term debt due within one year	**4,810**	4,103
Obligations under capital leases due within one year	**287**	309
Current liabilities of discontinued operations	**---**	89
Total current liabilities	**65,272**	69,345
Long-term debt	**41,086**	41,771
Long-term obligations under capital leases	**2,606**	2,788
Deferred income taxes and other	**8,805**	8,017
	---	1,491
Redeemable noncontrolling interest		
Commitments and contingencies		

FINANCIAL ACCOUNTING: FOUNDATIONS

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Conservatism Concept

CONSERVATISM CONCEPT

- Revenues are recognized only when they are earned.
- Losses are recognized even when there is uncertainty for the losses to happen.
- Provisions
  - reduce the value of assets or create a liability
  - recognize an expense in the income statement
  - Examples: provisions for accounts receivables, inventories, warranties, and contingent losses

CONTINGENT LOSS: EXAMPLE

A firm is sued for $1 million due to an environmental issue in year 2015.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Provision		IS	RE
Contingent liability							

CONTINGENT LOSS: EXAMPLE

A firm is sued for $1 million due to an environmental issue in year 2015.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Provision		IS	RE
Contingent liability				1		(1)	

CONTINGENT LOSS: EXAMPLE

A firm is sued for $1 million due to an environmental issue in year 2015.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Provision		IS	RE
Contingent liability Transfer to RE				1		(1) 1	 (1)
Closing Balance				1			(1)

CONTINGENT LOSS: EXAMPLE

The firm settles the lawsuit for $0.5 million in year 2016.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Provision		IS	RE
Opening balance				1			(1)

CONTINGENT LOSS: EXAMPLE

The firm settles the lawsuit for $0.5 million in year 2016.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Provision		IS	RE
Opening balance Settlement	 (0.5)			1 (1)		 0.5	(1)

CONTINGENT LOSS: EXAMPLE

The firm settles the lawsuit for $0.5 million in year 2016.							
	Assets		=	Liabilities	+	Shareholders' equity	
	Cash	AR		Provision		IS	RE
Opening balance				1			(1)
Settlement	(0.5)			(1)		0.5	
Transfer to RE						(0.5)	0.5
Closing Balance	(0.5)						(0.5)

FINANCIAL ACCOUNTING: FOUNDATIONS

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Fundamental Accounting Concepts and Revenue Recognition

Revenue Recognition

REVENUE RECOGNITION

- When does a firm book revenue in financial statements?

- What are the revenue recognition criteria?

- Expenses are matched to related revenues (matching principle).

REVENUE RECOGNITION CRITERIA

1. Revenue is earned.

2. Revenue is measurable based on objective and verifiable evidence.

REVENUE RECOGNITION EXAMPLES

- Sales: The company recognizes sales revenue, net of sales taxes, and estimated sales returns at the time it sells merchandise to the customer.

- Membership Fee Revenue: The company recognizes membership fee revenue both in the U.S. and internationally over the term of the membership, which is typically 12 months.

REVENUE RECOGNITION EXAMPLES

- The company records passenger ticket sales and tickets sold by other airlines for use on United as passenger revenue when the transportation is provided.

REVENUE RECOGNITION EXAMPLES

- The company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable.
- Product is considered delivered to the customer once it has been shipped, and title and risk of loss and rewards of ownership have been transferred.
- For most of the company’s product sales, these criteria are met at the time the product is shipped.

INDUSTRY VARIATION TO REVENUE RECOGNITION

- Long-term contracts: Percentage of completion method
- Natural resources and agricultural products: Completed contract method

ISSUES IN REVENUE RECOGNITION

- For sales of qualifying versions of iOS devices, Mac, Apple Watch, and Apple TV, the Company has indicated it may from time to time provide future unspecified software upgrades to the device's essential software and/or non-software services free of charge.
- Revenue allocated to the unspecified software upgrade rights and non-software services is deferred and recognized on a straight-line basis over the estimated period the software upgrades and non-software services are expected to be provided.

FRAUD IN REVENUE RECOGNITION

- A small appliance maker filed for bankruptcy in 2001.
- Engaged in massive revenue recognition frauds between 1996 and 1998:
  - Ship more goods than ordered by customers
  - Ship goods when the order is cancelled
  - Bill and hold: Sell goods under an early buy program where retailers can pay six months later and store the goods in Sunbeam’s warehouses
  - Book a sale and ship the goods to a warehouse rented by Sunbeam

SUMMARY

In this module, we learned:

- Fundamental accounting principles
- Accruals, deferrals, and provisions
- Revenue recognition criteria

In the next module, we will go through the accounting for short-term assets.