THEME: REVENUE REALIZATION PRINCIPLE

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ACCOUNTING TERM: Revenue

Revenue may be defined as the value of goods and services which a business enterprise transfers to its customers. Those goods and services are usually traded for cash or the promise of cash (accounts receivable) which results in an increase in the net assets on the balance sheet of the business. For instance:

DESCRIPTION	DEBIT	CREDIT
Cash	10,000	
Accounts Receivable	10,000	
Sales		20,000

If you need a quick reminder of how debits and credits work, click on this link http://www.reallifeaccounting.com/accounting_model.asp to review the "Accounting Model".

FEATURE ARTICLE: Realizing and Recognizing Revenue Under The Accrual Method Of Accounting.

Imagine the chaos in the business world if there weren't some rules governing when an increase in the value of the goods and services of a business enterprise took place. Financial statements would be meaningless. If I could report an increase in revenue before selling my products, how would I determine the value? What if I overstated the true value of my revenue which resulted in an increase in net assets on my balance sheet? Remember the "accounting equation":

Assets - Liabilities = Equity

When assets are increased, equity is also increased. This means I could easily distort the value of my company to attract investors and acquire loans. This problem was recognized early on, so it brought about the principle of "revenue realization".

Realization of revenue refers to the *timing* of its recognition in the accounting records. In other words, when the increase in value of the goods and services "really happened", that value was "recorded" (recognized) in the company's books. When you stop and think about it, each step in the production and distribution of goods and services is essential to earning revenue. Therefore, it is reasonable to assume that an increase in value is continually taking place. However, determining a continuous valuation is impossible, so an objective way of measuring the increase in value had to be developed. It had to be some kind of objective evidence that was *conclusive*.

When you buy goods or services from a company, you normally pay cash or some equivalent to cash. You consider it to be an even exchange. There is no gain or loss. When you sell your goods and services for a value higher than what it cost to purchase or manufacture them, then an increase in value occurs. When a sale is consummated, a contract between the buyer and the seller has occurred. A value has been objectively established and agreed upon by both parties. Revenue has now arisen in such a way that it can be measured and identified numerically. And, an exchange has been completed whereby legal ownership of the goods and services of one party have been transferred to another party.

Point of sale has been widely accepted as evidence of revenue realization. Yet, there are some situations which clearly show that “sale” and “revenue realization” are not necessarily synonymous. I’m referring to long-term contracts, installment sales, real estate investment contracts, when production is complete in certain industries such as farming, mining, etc. However, for most small businesses the actual sale of the products is the most important step in the earning process, and the only one with which to be concerned.

QUESTION: When Does The Transfer Of Ownership Of Goods And Services Actually Occur?

When services are rendered (performed) the contract is completed and the sale can be recorded. It’s the same for goods that are sold over the counter. These transactions are cut and dried. But what happens when goods are sold that have to be shipped to the buyer, i.e., “goods in transit”? When goods have left the seller’s premises and are in route to the buyer, who holds title? The passage of title from the seller to the purchaser marks the time when the legal responsibility for the goods changes from one party to the other. Therefore, it is usually stated in the sales contract “when” that point in time occurs. That point is normally indicated by the letters “FOB” meaning “free on board,” followed by the designation of a particular location, such as, “FOB Seattle”. This means that title is held by the seller until the goods are delivered to a common carrier in Seattle who will act as an agent for the buyer. Other FOB designations are “FOB point of destination” and “FOB point of shipment,” meaning that title passes at the buyer’s plant and at the seller’s plant, respectively.

As you can see, this process keeps things orderly because the seller has consummated the sale and is no longer in possession of the goods, and the buyer has received the goods and can now record the purchase cost to inventory. Or, can they? Technically the buyer now has possession, but normal practice is to recognize (record) the cost when the goods have reached their destination. The reason for this is to avoid a discrepancy of showing a certain inventory figure on the books that is not sustained by the inventory count. “Stuff” can happen on the way. Accidents, maybe a hijacking, but most likely some goods may be damaged and are unacceptable. The seller then has a “return”. The seller’s journal entries might look like this:

(1)

DESCRIPTION	DEBIT	CREDIT
Accounts Receivable	50,000	
Sales		50,000

(2)

DESCRIPTION	DEBIT	CREDIT
Sales Returns	5,000	
Accounts Receivable		5,000

Journal entry number 1 shows the increase to assets (Accounts Receivable) and an increase to revenue (Sales). Journal entry number 2 shows the decrease to revenue (Sales Returns) and the decrease to assets (Accounts Receivable).

It is important for the seller to track returns separately because, if there are too many returns, it is a signal there may be a problem in the shipping department, or elsewhere.

TIP: Realizing And Recognizing Revenue When Using Cash Basis Accounting Method.

Many small businesses use the cash basis method of accounting, so you may be wondering how revenue realization and recognition applies to them. Using cash basis method in its purest form means revenue is realized and recognized when cash is actually received. Expenses are recognized only when cash is paid. Yet, many small businesses also use a “hybrid” method that is part accrual and part cash. A business might use a hybrid method that includes accounts receivable but no accounts payable, or vice versa, or both. For example, if a business using the hybrid method included accounts receivable but not accounts payable, then it should follow the revenue realization and recognition rules mentioned above. But, expenses would be recorded only when cash was actually paid.

Another application of revenue recognition when cash is received is the Installment Method of accounting. Installment sales (sales contracts that call for payment in periodic installments) delay the recognition of revenue until the payment is received. This is done through a liability account called “Deferred Income”. It is probably easiest to understand how this works by following a series of journal entries. For instance:

(1)

DESCRIPTION	DEBIT	CREDIT
Accounts Receivable	10,000	
Deferred Income		10,000

(2)

DESCRIPTION	DEBIT	CREDIT
Cash	500	
Accounts Receivable		500

(3)

DESCRIPTION	DEBIT	CREDIT
Deferred Income	500	
Sales		500

Notice that in journal entry number 1, Accounts Receivable (an asset) and Deferred Income (a liability) offset each other so that there is no increase in Equity. Then, in journal entry number 2, cash is received and decreases Accounts Receivable and simultaneously increases Cash (an asset), also no change in equity. Since the cash was received, the revenue can be recognized in journal entry number 3, by decreasing Deferred Income and increasing Sales (revenue). Now there is an increase in net equity of $500.

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