

Recognition Position Paper

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Accounting for Managerial Decision Making

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## ***Memorandum***

To: Chief Executive Officer, Ace Manufacturing

From: Team A –Team M1, Big Picture Consulting

Subject: RECOGNITION POSITION PAPER

Date: August 21, 2004

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This memorandum is reflective of Team A's, Big Picture Consulting, recommendations to Ace manufacturing for the recognition of revenues and expenses.

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Revenue and expense recognition is the process of identifying and recognizing the sources of revenues or expenses and is crucial to reporting corporate performance. We have entered into a new era in corporate responsibility and are now holding top-level executives accountable for their organizations fiduciary responsibilities as changes in reporting requirements and methods evolve. The Financial Accounting Standards Board (FASB) with pressure from the Securities and Exchange Commission (SEC) is moving forward to standardize the revenue and expense recognition requirements and methods in place to regain private and public trust of corporations after many large-scale public corporation scandals. The recognition process includes:

- Definition – Is the item an asset, liability, equity, revenue, expense, gain or loss?

- Measurability – Does it possess the characteristics that permit reliable measurement?
- Relevance – Will it make a difference to the decision maker?
- Reliability – Is it a faithful representation?

These questions and thoughts, in the recognition processes should be followed when determining revenue and expense recognition. This sets in place the foundation for the revenue recognition principle.

### Revenue

The FASB defines revenues as “inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations” (FASB, 1985, para. 78).

Realization means that the product or service has been exchanged for cash, claims to cash, or an asset that is readily convertible to a known amount of cash or claims to cash. Thus the expectation that the product or service provided by the firm will result in a cash receipt has been fulfilled (Marshall, McManus, and Viele, 2004, p. 312.).

Earned means that the entity has completed, or substantially completed, the activities it must perform to be entitled to the revenue benefits (i.e., the increase in cash or some other asset, or the satisfaction of a liability). The realization and earned criteria for recognizing revenue usually are satisfied when the product or merchandise being sold is delivered to the customer or when the service is provided (Marshall, McManus, and Viele, 2004, p. 312.).

Certain criteria must be met for revenue recognition. First, a company or firm has substantially accomplished what is necessary to be entitled to the

benefits represented by the revenues. Second cash is collected or is reasonably, and likely to be collected. Only then, when these two criteria are met revenue is realizable.

The SEC in 1999 issued Staff Accounting Bulletin (SAB) 101 pertaining to revenue recognition. "SAB 101 emphasizes the two revenue recognition criteria: realized (or realizable) and earned. The SEC staff has also issued guidelines that the two criteria are met when all of the following criteria are established:

- Persuasive evidence of an arrangement exists
- Delivery has occurred or services have been rendered.
- The seller's price to the buyer is fixed or determinable.
- Collect ability is reasonably assured". (Briner, 2001, para. 5)

The following practices were identified as practices that were of concern to both the SEC and the FASB:

- Bill and hold transactions,
- Long-term contract arrangements,
- Barter advertising transactions,
- Agent or facilitator transactions.

Recommendations are:

- "Individuals recording and auditing revenue should have a high level of knowledge of GAAP for revenue recognition. In addition, audit committees should be keenly aware of subtler issues and make appropriate inquiries.
- All relevant individuals should be knowledgeable about recent revenue recognition guidelines, including SAB 101 and FASB: Emerging Issues Task Force (EITF) 99-17 and 99-19.

Where revenue recognition may be questioned such as in the above cases the financial statements should make the appropriate disclosures and inform users of the “grossing up” of the transactions if the transactions are not reported net of revenue earned” (Briner, 2001, para. 20).

### *Recognition Methods*

There are four ways for revenue to be recognized. They are:

- Revenue from selling products, which is recognized at the date of sale,
- Revenue from services is recognized when service is performed and is billed,
- Revenue from the use of firm assets as time passes or the asset is used, and
- Revenue from the disposal of assets is recognized at the point of sale.

Ace Manufacturing provides a product; therefore, it is recommended that the majority of revenue recognition will be in the sales of the product. The remaining revenue recognition will be accomplished from percentage of completion. Additionally, revenue may be recognized for the assets of the company and its disposal of the assets when required.

### *Sales Method*

Sales are the most commonly recognized revenue, sometimes referred to as point of sale. Revenues result from the sale of a product and not the receipt of cash. There are many methods to record revenue transactions and this has led to many differences in how the sales revenue is recognized. According to the

standards that are currently in place, the time of revenue recognition is normally when the product is delivered. These revenues will be reported on the beginning of the income statement.

#### *Percentage of Completion Method*

Since many of ACE's products could take more than a year to complete, revenue may be recognized at various stages of completion. Delaying the recognition of revenue until the product is delivered could result in misleading information being reported on the income statement for many years. Revenue may be recognized under the percentage of completion method, for sales that have a buyer and a contract for specified price.

#### *Assets*

Plant, property or equipment assets that are used in manufacturing may be considered as revenue. In addition, in plant, property or equipment that is disposed of by sale may be included for revenue.

#### *Expenses*

The FASB defines expenses as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations" (FASB, 1985, para. 80).

#### *Expense Recognition Methods*

Expense recognition is best recognized, and the majority of expense recognition is accomplished, using the matching principle method. Expenses are

recognized in relation to the revenues. The expenses are incurred to support the generation of the revenue.

Several expenses are recognized in the current period calculations and are clear-cut. Cost of goods sold, depreciation and long term assets are examples of clear-cut expenses. Some are more complex, such as income tax expense and pension expense, and require a significant amount of recognition and measurement to be properly calculated. For expense recognition it is recommended that Ace Manufacturing use Cost of Good of Goods and Straight Line Depreciation methods.

#### *Cost of Goods Sold Method*

Cost of goods sold is usually the largest expense a company will have. The cost flow methods of FIFO, LIFO and average cost involved have a significant role in this calculation.

“Cost of goods sold is sometimes phrased as COST OF SALES. The cost of goods sold is the costs actually incurred in producing the product or service. It is the direct costs of production. It does not include the indirect costs, which may be things like administration and marketing costs. These cannot be directly attributed to producing the product and so are not included. The cost of goods sold for a production company will include things like raw materials, energy and labor used to produce the product. For a retail company it will be the total amount they have paid to their suppliers for the products they sell on the shelves” (Biz/ed, 2004, para. 1).

### *Straight Line Deprecation Method*

Straight Line Depreciation is the simplest and most commonly used form of depreciation. Expenses are incurred by allocating the cost of the assets of the assets useful life. Depreciation is calculated by:

$$\text{Purchase price of asset} - \frac{\text{approximate salvage value}}{\text{Useful life of asset}} \quad (\text{Kennon, 2004, para. 1}).$$

### Expensing of Stock Options

#### *Pros*

There are many positive reasons to expensing stock. The International Accounting Standards Board (IASB) has stated the European Union companies will expense stock options within five years. If the FASB does not want to appear substandard, they will follow the IASB.

Stock option expensing will not affect the actual earnings of any company. Company's actual earnings are what they are. It is easy to learn the amount of the stock options dispensed. Publicly traded companies are required to reveal this information in their financial statements, so anyone who is interested can look it up. Changing the way they reveal the information will not be a big deal. It will better reveal a companies costs and financial health to investors that do not know how to read the companies financial statement.

Stock options allow employees to buy their company's shares at a set price, and then sell after a specified period if shares rise.

Adopting stock expensing may keep executives from using risky business strategies to bolster quick growth in stock prices.



Expensing stock options may help control the growth of executive compensation. It will close a loophole that stock options do not have value.

Management is largely pro expensing.

### *Cons*

The management of tech companies says outsourcing jobs to India and China may increase as costs for American workers increases if they are to expense stock options. Some say this is management's form of political extortion.

Most people in management are against expensing stock options. Management warns that expensing options will depress earnings and cause further declines in share prices, and if it is decided to curtail the use of options because of having to expense them, they will lose a valuable tool to recruit employees and motivate executives. Continental Airlines CEO Gordon M. Bethune says, "When management doesn't have skin in the game, they don't have any interest in what happens to the share price" (Borus, Dwyer, Foust and Lavelle, 2002, para. 8). In other words, management will not be as concerned with the profitability of a company if they have to expense stock options.

Some in management have stated; deducting the cost of stock options on the income statement will reduce earnings. This in turn will trim the earnings per share, making stocks appear more expensive to investors.

If stock options are expensed, they may disappear to rank and file employees. This will cut down on stock options being used by startups to lure or attract top engineers, making it more difficult to operate a startup business.

If the value of options offered and exercised shrinks by 25%, individual income tax payments from stock options would drop by about \$ 15 billion. The federal budget deficit could take a hit. This would be significant in light of the billions in budget deficit.

Normally a company will not be taken public with an initial public offering until it is making a profit. When stock options are expensed raising capital will be difficult. In the viewpoint of management, expensing will make it difficult to show a profit.

Managers are doing what they have been hired to do, which is working to make the company profitable. Management will do what it takes to show a profit.

#### Justification

##### *Recognizing Revenue*

Ace Manufacture will be producing a product for sales, and the sale method is the best method to recognize revenue for manufacturing. The percent of completion method will be beneficial to the organization for revenue recognition for those whose contract over one year. This is done so revenue maybe recognized, and misleading information on the financial reports will not be published. Any other methods are not recommended because they are not the best fit for the company. The installment method is not recommended due to sales and the costs of goods are deferred to periods of collection. We feel that this is an unacceptable risk for this manufacturing firm. The cost recovery method is not recommended because most accounts with the company are

determined to be collectable. Cost recovery is normally used where there is not a reasonable basis for recovery.

### *Recognizing Expenses*

Utilizing the matching principle Ace manufacturing should strive to match expenses to revenues where possible. Special assistance maybe required to assist in the complex calculations and application of requirements for income expenses and pension expenses.

### *Expensing of Stock Options*

Clearly, there will be emerging and new requirements as we head into the future. The expensing of stock options could be a better reflection of the company's overall economic reality. Commitment to the best practices in the financial reporting world will take the company far into the future. The expensing of stock options will put the various forms of present day employee options on an equal playing field. It is recommended that Ace Manufacturing expense stock options.

Managers are against expensing because it may curtail the large stock options they have received in the past, and make their job more difficult. They are using any scenario they can to stop expensing. There are a hundred companies that have seen the light, and realize that expensing is going to happen and have already started expensing stock options. This gives a more up front picture of the company and will only change the way things are documented.

(Signed copy on file)  
Team A – Team M1  
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### Conclusion

This memorandum has provided Team A's, Big Picture Consulting, recommendations to Ace Manufacturing, for the recognition of revenues and expenses. The recognition of revenue and expense is crucial to reporting corporate performance as changes in reporting requirements and methods evolve. In order to meet the challenges Ace Manufacture is moving forward to standardize the revenue and expense recognition requirements and methods in place to regain private and public trust across corporate America. With this knowledge and recommendations if followed Ace Manufacturing will be the premier organization of the future.

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