Recognition Position Paper

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As a consulting firm we would like to express our recommendations for your company for recognizing revenues and expenses.

Basically, the revenue recognition principle is one of the four main principles in the US generally accepted accounting principles. In addition, it is the main difference between cash basis accounting and accrual basis accounting. In cash basis accounting, revenues are recognized when cash is received regardless of when and how the services were performed or goods delivered. In accrual basis accounting revenues are recognized when they are realized and earned, regardless of when the cash is received.

The general rule for the standard method are revenues are realized when goods and services are exchanged for cash or claims to cash (receivables). Revenues are realizable when assets received in exchange are readily convertible to known amounts of cash or claims to cash. Revenues are earned when the entity has performed its duties to be entitled to compensation.

There are 4 main transactions of this kind:

1. Revenue from selling inventory is recognized at the date of sale (usually interpreted as the date of delivery).

2. Revenue from performing services is recognized when services have been performed and are billable.

3. Revenue from permission to use company's assets (e.g. interests for using money, rent for using fixed assets, and royalties for using intangible assets) is recognized as time passes or as assets are used.

4. Revenue from selling an asset other than inventory is recognized at the point of sale.

The percentage of completion method states if

1. The contract clearly specifies the price and payment options with transfer of ownership

2. The buyer is expected to pay the whole amount and

3. The seller is expected to complete the project, then revenues, costs, and gross profit can be recognized each period based upon the progress of construction (that is, percentage of completion).

For example, if during the year, 25% of the building was completed, the builder can recognize 25% of the expected total profit on the contract. This method is preferred. However, expected loss should be recognized fully and immediately due to conservatism principle.

Completed contract method should be used only if percentage-of-completion is not applicable or the contract involves extremely high risks. Under this method, revenues, costs, and gross profit are recognized only after the project is fully completed. Thus, if a company is working only on one project, its income statement will show $0 revenues and $0 construction-related costs until the final year. However, expected loss should be recognized fully and immediately due to conservatism principle.

Regarding what is expense and loss recognition, we want to to inform you that In order to determine your income, you must establish criteria for revenue recognition and the principles for recognizing expenses and losses must be clearly defined. Some expenses are directly associated with revenues. These expenses can be recognized in the same period as the related revenues. Other expenses are not associated with specific revenues. These expenses are recognized in the time period when they are paid or they are incurred. Still, other expenses are not recognized currently as expenses because they relate to future revenues; therefore, these expenses are reported as assets.

Expense recognition, then, can be divided into three sub-categories: direct matching, systematic and rational allocation, and immediate recognition.

1 Direct Matching

In order to perform direct matching, you must relate your expenses to specific revenues. This is referred to as the "matching" process, in which your revenues that are produced by the sale of goods and reported in the same time period are recognized. Similarly, shipping costs and sales commissions are usually directly related to revenues. Your direct expenses include not only those expenses that have been incurred, but also anticipated expenses that are related to revenues of the current period. After the delivery of goods to your customers, there are still costs of collection, bad debt losses from uncollectible receivables, and possible warranty costs (for product deficiencies). These expenses are directly related to your revenues and should be estimated and matched against recognized revenues for the accounting period.

2 Systematic and Rational Allocation

The second general expense recognition category involves assets that benefit more than one accounting period. The cost of assets, such as buildings, equipment, patents, and prepaid insurance, need to be spread across the periods of expected benefit in some systematic and rational way. Generally, it is difficult to relate these expenses directly to specific revenues or to specific periods; however, these expenses are necessary if your revenue is to be earned. Examples of expenses included in this category are depreciation and amortization.

3 Immediate Recognition

Many expenses are not related to specific revenues, but are incurred to obtain goods and services that indirectly help to generate revenues. Because these goods and services are used almost immediately, their costs are recognized as expenses in the period of acquisition. Examples of immediate recognition items include most administrative costs, such as office salaries, utilities, and general advertising and selling expenses. You will find immediate recognition appropriate when your future benefits are highly uncertain. For example, your expenditures for research and development may provide significant future benefits, but they are usually so uncertain that the costs can be written off in the period in which they are incurred. Most losses also fit in the immediate recognition category. Because they arise from peripheral or incidental transactions, your losses do not relate directly to revenues. Examples of losses in the immediate recognition category include losses from disposition of used equipment, natural catastrophes (i.e., earthquakes or tornadoes), and losses from disposition of investments.

The methods you adopt for recognizing expenses and losses should appear reasonable to an unbiased observer and should be followed consistently unless the underlying conditions surrounding the assets change. Some expenses are related to the goods your company produces. These expenses may be deferred in inventory values if the goods are unsold at the end of an accounting period. Examples of expenses deferred in inventory values include depreciation on production machinery and plant insurance. Other expenses are related to accounting periods and should be allocated directly as an expense of the immediate time period. Examples of this include depreciation of delivery trucks and amortization of bond discount.

You also need to know that expensing stock options is very controversial in corporate America. The pros and cons are weighed by each organization to determine if their best interest is at heart. In 1991, (FASB) the Financial Accounting Standards Board introduced a proposed new accounting standard around stock options. This new standard would allow a company to reduce its net income by allowing the company to expense the value of the option at the fair value of the stock on the grant date. A stock option journal entry on a balance sheet would be recorded as a credit …(ADD THIS IN) A stock option journal entry on a income statement would be recorded as a credit cash and debit to (ADD THIS IN) Several discussions around this issue had both positive and negative impacts on the company. According to McPeak from a pro perspective, expensing options will provide a level playing field so the company cash bonuses and companies that use stock options each have the income statement. It will improve corporate governance by reducing or eliminating incentives to inflate income and earnings per share and reduces revenue. (McPeak, 2002) The bottom line here is personal gain for the company. Each company will use this method to best benefit the company for personal gain. The cons have some key points that indicate this could be a way for a company to take advantage of stock options and maybe viewed as a cover up. According to some public investors, “I would never buy into a stock if the company does not expense options. Not doing so tell’s me the managers don’t just fudge: they cheat. And if they are duplicitous in this regard, of course they will push the envelope and try to use every accounting trick to pump up their revenues and earnings.” (Day, 2003) In a recent account scandal at Enron, it was identified that they failed to expense their options which led to legal ramifications. By doing so, they failed to report profits in the amount of a 10% increase. Both the income statement and balance sheet conveyed two different entries. Enron is among many companies having been identified as misusing the rules for stock option accounting. In conclusion, many organizations have and will deviate from the rules of the stock option accounting and will either discourage or prove that stock options have its advantages and disadvantages based on the company intentions. Stock options will continue to be a controversial issue in the accounting arena. Accountants will frowned up as abusing stop options due to lack of trust based on other company scandals. According to McPeak, the SEC could help organizations make the right decisions around stock options by implementing limitations on the percentage of a company options along with using options on a restricted stock and must be held for two years before being sold. (McPeak, 2002)

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