

Just in time concept

[Philosophy](#)



**ASSIGN
BUSTER**

Financial AccountingS. Das Income Measurement and Accrual Accounting
Recognition and Measurement in Financial Statements DEFINITIONS
Revenues: inflows of assets or reductions in liabilities from selling goods and services
Expenses: outflows of assets or increases in liabilities used up in generating revenues.
Recognition formal recording of an item in financial statements, in words and numbers
Measurement quantify the effects of economic events numbers unit is money- dollars historical cost - recorded for simplicity, verifiability, reliability Current cost-relevant but less reliable

Only an estimate until item is sold $\text{Net income} = \text{Revenues} - \text{Expenses}$.
Income amount of resources available for consumption at the end of a period and yet be as well off as it was at the beginning of the period. CASH BASIS
Versus ACCRUAL ACCOUNTING So if we DEFINE PERIOD to be lifetime of a firm (which can only be defined for a firm with a finite life) then we are only interested in the earnings of a firm over its lifetime. In that case: a. just wait until the firm dissolves. b. Add up all the cash inflows over its lifetime other than those for sale of own stock. c.

Add up the cash outflows over its lifetime other those for stock repurchase or dividends. d. Find the difference between cash inflows and outflows and YOU HAVE NET INCOME. e. THE ABOVE IS ALWAYS TRUE. However, if you DEFINE PERIOD TO BE ANY INTERVAL SMALLER THAN THE LIFE TIME when you wish to get information on earnings as intermediate feedback, then there is the following problem: -transactions may not be complete on a cash to cash basis - because the earnings process is continuous - Period1 buy inventory for \$5 Period2 pay for inventory Period3 sell and deliver inventory for \$15

Period 4 receive payment from customer. KEY Question When should revenues and expenses be recognized? One possibility is the cash basis recognize revenues at time of receiving cash and recognize expenses at the time of paying cash. Example: A toy retailer starts business on January 1, 2000. The retailer Mr. XYZ pays two months rent in advance on his store for \$2000. He also purchases and pays for toys worth \$35,000. However, during the month of January, he sold no toys. During February, he sells all the toys he has for \$45,000 but collects only \$5000 of that in cash.

He expects the neighborhood children to pay the remaining \$40000 in March.

Jan	February	Revenues-----	Less: Expenses	Cost of
toys-----	Rent-----		Total	Expense-----
Income-----				

Limitations of Cash basis 1. expenses are not aligned in time with the revenue that they produce. 2. recognition of revenue is unduly postponed.

A Second possibility is the use of Accrual basis - depends upon when some critical event occurs. What happens to income (accrual basis) using same example?

Jan	February	Revenues-----	Less: Expenses
Cost of toys-----			
Rent-----	Total	Expense-----	Income-----

Comparing the Cash And Accrual Bases of Accounting -Basic difference one of timing Recognize Revenue when Recognize Expense when Cash Basis cash is received cash is paid Accrual Basis revenue is earned it is incurred

Exhibit 4-2 transparency Accrual matching of expenses with the corresponding revenues OR match resources used (expired assets- expenses) to generate revenue.

The accrual concept forces accountants and managers to focus on changes

in owner's equity rather than merely reporting changes to the cash or other assets.

The realization concept underlies the decision rules that accountants use in determining when revenues should be recognized and expenses matched to them. The Revenue Recognition Principle Revenue: Increase in Asset Or Decrease in Liability from Delivery of Goods Or Services Realized: Goods Or Services Exchanged for Cash Or Promise of Cash . Earned: Revenue earned when realization is complete or no significant obligations left How are Revenues recorded? •At the same time as cash is collected. •Before the time cash is collected. •After the time cash is collected. Possible Interpretations of Recognition Principle:

Percentage of Completion: For long term projects, revenue recognized as stages are completed, based upon proportion of total cost incurred, Franchises: Initial fee recognized as revenue only FAS 45 "substantial performance" of its obligations B&J 32 Production Method Commodities - Traded at established price; so revenue recognized when they are produced. Installment Method: opposite of production method: no reasonable basis to estimate collectability, so revenue on sale recognized as cash is collected Continuously: such as rent and interest

The criteria used in accounting to decide the recognition of revenues is : •A firm has performed all, or a substantial portion, of the services it expects to provide. •The firm has received cash, a receivable, or some other asset whose cash equivalent it can objectively measure. Expense Recognition and the Matching Principle The matching concept relates revenues and expenses so that owner's equity is neither overstated nor understated at any points in

the stream of events that constitutes operations. Expense when an Asset Has No Future Benefit i. e. It Is Used Up [Or] a Liability Is Incurred.

Matching: Associate Revenues with Costs (expenses) Necessary to Generate them Unexpired Sometimes not done with specific items of product sold, but with period in Assets which they were sold eg. sales clerks' salaries are expensed in the period in which employees worked. Expired Some things never go through asset stage, since benefit is seen to expire as soon Assets as costs expended (purchased) = Period Costs; eg. utilities costs, telephone, fuel for vehicles (not asset) Two examples: 1. Expired asset versus 2. Expensing of benefits/ resources that never went through asset stage.

A. Depreciation Expense estimated useful life and eventual salvage or resale value Manipulation to increase or decrease income Salvage deducted before calculating periodic expense because it is expected to be recovered and will remain an asset. B. Research ; Development Dell Computer in its 1995 Annual Report list “ Research, development and engineering” of \$65, 361, 00 as operating expense on Income Statement. - an expense is an asset whose usefulness to the company is complete - it is deemed that R; D has no future benefit left hence out right expense without going through asset stage.

For an accrual based company, Statement of Cash Flows provides information on Sources and Uses of Cash. Accrual basis necessary because we divide the earning of income, a process that takes place over a period of time, into artificial segments (reporting periods). Example: In the 1995, Income Statement Maytag Corporation had a net loss of \$20, 476, 000. Their Statement of Cash Flows showed an increase in cash equivalents of \$30,

811, 000. Cash provided by operating activities was \$319, 979, 000. How can a company with a net loss have a gain in cash?

This is possible if expenses exceeded revenues since Income statement is on accrual basis. It contains revenue amounts that may not have been realized in cash (still in accounts receivable) and expenses that may not have been paid for such as depreciation, and unpaid purchases. Also look for income from continuing operations versus loss due to extraordinary items and disposal of existing business. (As was the case in Maytag 1995) Accrual Accounting and Adjusting Entries: at end of period - Four Types: 1. Deferred Expense: Cash Paid before Expense Is Incurred

Asset created; as asset expires it becomes an expense, via adjusting entry
 Entry During Asset End of Expense period Cash period Asset eg. * prepaid rent becomes rent expense, a month at a time * Depreciation allocates cost of asset over its useful life - does not measure decline in value ? Based on estimates of salvage value and life of asset ? Periodic expense = $[\text{actual cost} - \text{est. salvage value}] / \text{estimated life}$? debit is depreciation expense ? credit is not to asset account, which will always reflect cost, ? but to accumulated depreciation- contra account that is, an asset account with a credit balance
 2. Deferred Revenue Cash Received before Revenue Is Earned Liability Created Because Goods Or Services Still Owed Entry During Cash End of Liability period Liability period Revenue ? Eg. unearned " the other company" from deferred expense entries ? for example, The landlord who received the prepaid rent has a deferred revenue ? liability is reduced, revenue increased, as time passes ? magazine subscriptions received in advance, earned as magazines mailed
 3. Accrued Liability Expense incurred before Cash Is Paid

Opposite of deferred expense Entry During-End of Expense period- period
 Liability Eg. taxes, payroll, utilities; interest for short term loan paid at
 maturity with principal 4. Accrued Asset Revenue Earned before Cash Is
 Received Opposite of deferred revenue Entry During-End of Asset period-
 period Revenue ? both rent and interest are earned as time goes by,
 regardless of when cash received ? need adjusting entry if payment is not
 received. Exhibit 4-5 (text pp. 165) Example: P4-2 REVISITING THE
 ACCOUNTING CYCLE Steps taken to collect the necessary information to
 prepare financial statements (Exhibit 4-8) . Collect and Analyze 2. Journalize
 Events 3. Post to Ledger Accounts (Results in Unadjusted Trial Balance) 4.
 Journalize and Post adjustments (Results in Adjusted Trial Balance) 5. Prepare
 Financial Statements 6. Journalize and Post Closing Entries (Results in Post-
 Closing Trial Balance) 7. Post Closing Trial Balance 8. Optional: Reversing
 Entries The Closing Process: Two types of accounts: Balance Sheet= real
 accounts = permanent Income Statement= nominal accounts = temporary
 (Includes Dividend account) Purpose of closing entries:-Close temporary
 accounts -transfer net income (loss) to retained earnings

Process of closing: Debit Each Revenue Account: Sum Up a Single Credit to
 Income Summary. Credit Each Expense Account, Sum Up a Single Debit to
 Income Summary. Debit Income Summary If It Has a Credit Balance
 (Company Had Net Income) OR Credit Income Summary If It Has a Debit
 Balance (Company Had Net Loss) Credit Dividend Account, Debit Retained
 Earnings Exhibit 4-9 (text pp. 171) Example 1: E4-23. Ben ; Jerry's Example
 2: Let us look at McDonald's Corporation's 1998 Statement of Income shown
 on Page 139 of your text. Note a. Retained Earnings at the beginning and end

of 1998 were \$12, 569 and \$13, 879. million respectively. b. Total dividends paid to common and preferred shareholders were \$239. 5 Use the numbers from the Income Statement to Reconstruct the relevant account balances. Then Close them to Income Summary and from there to Retained Earnings. EXAMPLE P4-10 Post-closing Trial Balance will only contain Balance Sheet accounts.

When is a sale a sale? In an article concerning troubled MiniScribe Corporation (The Wall Street Journal September 12, 1989 - MiniScribe's Investigators Determine That " Massive Fraud Was Perpetrated".) it was stated that " ... he company dramatically increased shipments to three warehouses, booking \$56. 4 in sales and gross profit of \$5. 4 million. " (Note that the warehouses being shipped to belonged to MiniScribe) The volume of shipments only called attention to the problem - it was not the problem. Problem is it is not Customer's warehouse but MiniScribe's - shipping goods to ones? own warehouse is not a sale - but a relocation of inventory - must be an arm's length transaction.

This was one among many violations - MiniScribe was also shipping bricks to an fictitious company, and recording them as sales revenue. 1. Claiming Tomorrow's Profits Today, Forbes, October 17, 1988, p 78. Case 4-1: Ben ; Jerry's Revenue Recognition - Initial Franchise Fee Footnote on 147 of text. FASB SFAS 45 allows franchisor to recognize initial franchise fee as revenue only when " substantial performance" of its obligations and when collection of the fee is reasonably assured. Revenue Recognition: The Company recognizes franchise fee as when services required by the franchise agreement have been substantially performed.... 1. Consistent with SFAS 45.

The footnote refers to certain mandatory services that the company promises to perform for the new stores. Performance of these services is the basis for recognizing the fee as revenue. Note that the footnote specifically uses the wording substantially performed. 2. The company recognizes the franchise fees as revenue in proportion to the stores for which the required services have been substantially performed. 3. Franchise fees are not large relative to net sales in any of the years. Franchise fees are less than 0.4% of net sales in each of the three years. Unearned Revenue: Realizability Vs.

Earned criteria - realized BUT has it been earned?. 1. Case 4-2: Gateway- Revenue Recognition Refer to page 30 of Gateway's Annual Report, under "Summary of Significant Accounting Policies" 1. Gateway recognizes revenue from product sales when products are shipped. Revenue from separately priced extended warranty programs is deferred and recognized over the extended warranty period. 2. "Extended warranty programs" are contracts to service products for a period beyond the original warranty. These contracts are purchased for an additional amount above the product purchase price. . The revenue from the extended warranties is recognized over the warranty period because it is earned over the entire period, as coverage is provided. 2. Case 4-3: Sears, Roebuck, ; Company - Revenue from Service Contracts. 1. Under the accrual basis, revenue should be recognized when it is earned, rather than when cash is received. Since the retailer incurs costs to repair damages over the life of the service contract, the revenue from the contract is also earned over the life of the contract. 2. Revenue to be recognized each year: Year 1 Year 2 Year 3

Sales Revenue Service Contract Total revenue Typically, for service contract you receive cash or payment, for future services, that creates a liability. Thus one has an unearned revenue account. In this particular example, the liability account would contain XXX at the end of year 1 and XX at the end of year 2 reported under current liability as unearned revenue on the balance sheet. Sears, Roebuck, ; Company 1998 Annual Report Footnotes to Revenue Recognition The Company sells extended service contracts with terms of coverage between 12 and 36 months.

Revenue and incremental direct acquisition costs from the sale of these contracts are deferred and amortized over the lives of the contracts. Costs related to servicing the contracts are expensed as incurred. 3. American Airlines: 1996 total revenues of \$17, 753 million. Balance sheet reported ? Air traffic Liability? of \$1, 889 million. - unearned revenue (~11%) from ticket sales. -when retired - Retired when ticket holders are provided transportation. -Refundability a factor -What if carrier cannot provide service due to strike or storm. -When is revenue earned ? - when ticket is bought when passenger boards - when plane takes off - when the round trip is complete. AMERICAN AIRLINES 1998 Annual Report (Summary of Significant Accounting Policies) (Note 1) PASSENGER REVENUES Passenger ticket sales are initially recorded as a component of air traffic liability. Revenue derived from ticket sales is recognized at the time transportation is provided. However, due to various factors, including the complex pricing structure and interline agreements throughout the industry, certain amounts are recognized in revenue using estimates regarding both the timing and the

amount of revenue to be recognized. Actual results could differ from those estimates.

In 1998, American showed revenues of \$17, 449 million and recorded " Air traffic liability" of \$2, 163 million on its Balance Sheet. Time Warner Inc. According to Annual Report they publish 26 different magazines. At end of 1998 unearned subscription revenue was \$741 million. -included in their is your paid subscription to Time for issues that you have yet to receive. - magazines are sold at different rates depending on how you subscribed and for how long. - how to keep track of when earned. when does the earnings process complete When subscription received - if main source of revenue is advertising. When production is complete and delivery is made. A combination of these two. Note that Time does not have difficulty to keep track since subscription price variations and customer records are all kept by computers - closely monitor the process from payment to through unearned revenue to delivery and revenue earned. Time Warner Inc. 1998 Annual Report (Note 1) The unearned portion of paid subscriptions is deferred until magazines are delivered to subscribers.

Upon each delivery, a proportionate share of the gross subscription is included in revenues. E 4-81. AugustCash Subscriptions Received in advance (Unearned Revenue) To record collection of 900 subscriptions Assets = Liabilities+ Owner's Equity 2. August 31. Unearned revenue Subscription revenue To record subscriptions earned during August. Assets= Liabilities+Owner's Equity 3. Net income for the month of August would be under stated / overstated by XXX if the accountant forgot to make the entry

to recognize revenue earned. (Self Note: Also see Magazine Subscription case) E 4 -9