

# Knowing the Right Time to Recognize Revenue

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Products and services can be sold and marketed in many different ways. Guidance is available about how to recognize revenue (record income) from the most common types of transaction, but it's not possible to provide for every situation—so considerable professional judgment is needed in the less straightforward cases.

## What You Need to Know

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### How are revenues accounted for?

Revenues are accounted for using one of two methods. The cash basis simply recognizes revenues at the time they are received. The accrual basis—which most businesses are required to use by law—reports income when it is earned (regardless of when it is received), and expenses when they are incurred (no matter when, or if, they get paid).

### Is there any professional guidance about recognizing revenues?

In relation to the accrual method of accounting, there is plenty of advice and information available. For example, the *Generally Accepted Accounting Principles* (GAAP), issued by the Financial Accounting Standards Board, provide a set of standards for recognizing revenues. The “statements of position” published by the American Institute of Certified Public Accountants (AICPA) are another source of guidance, and public companies can get information from the Securities and Exchange Commission (SEC).

### How are non-operating activities recognized?

Non-operating activities are those that do not fund a company's main operation. Revenues from such activities (like the sale of assets, rental income, or interest revenue) are recognized using the same criteria as operating revenues, but are reported under “other income” in financial statements, or as a reduction in a corresponding expense (such as rental payments).

## When can revenue be recognized?

A company can recognize revenue from the sale of products and services at many different points during a transaction, depending on the accounting method used, and on industry practice. For example, revenues can be recognized when a product is produced, when it is sold, or when it is paid for. Most typically, they are recognized at the point the customer pays and takes over ownership, but this simple approach is by no means the only one.

## What to Do

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### Identify the Right Time for Your Business

Under the cash basis of accounting, revenue is recorded when the customer pays. But most firms use the accrual basis of accounting, which obliges them to recognize revenue at the moment it is earned, rather than when it is received. Judging exactly when this happens is not always obvious, so criteria have been drawn up. Depending on the product or service in question, revenues can be recorded when:

- there is an exchange arrangement;
- the company delivers its product or carries out its service;
- the price to the customer is fixed and measurable;
- the company is reasonably confident that the customer will pay.

### When there's a return policy

Most retailers offer their customers a return policy in case there's a problem with the goods, or the purchase is unwanted. So even though the customer has paid and ownership has been transferred, there is a risk that the transaction will fail and that the retailer will have to take back ownership and refund the purchase price. There are three different ways of handling this:

- the revenue is not recognized until after the return period has expired
- all sales are recognized, but a reduction is made to take account of possible returns
- all sales are recognized, and adjustments are made if and when goods are returned.

On the statement of income, any reduction in revenue for customer returns is usually reported as "net sales."

### When markets and prices are predictable

In some sectors, sales and prices are more or less pre-determined. In such ready markets, particularly when distribution costs are low, revenues are typically recognized at the time of

production. Commodities like wheat or iron ore will be sold at the current market price to major international companies, so it's common practice to recognize revenues at the time—in these examples—of harvest or extraction.

## **Long-term contracts**

Long-term contracts that extend beyond a single accounting period present different issues. Examples might be construction projects, or ongoing contractual arrangements. Both parties in the contract have rights: the buyer to a product or service, and the provider to payment. This is acknowledged in the way revenues are recognized.

One method recognizes revenues according to the percentage of the contract that has been completed. In the construction industry, this is usually calculated by comparing the costs incurred to date with the total estimated costs. Consultancy projects may base their calculations on the number of hours spent so far, compared with the total estimated number.

Alternatively, a project can be divided into stages or milestones. Revenues associated with particular stages are recognized on their completion, and so on until the contract is finished.

## **Revenues from assets loaned**

If a company loans out its assets, whether tangible (like renting office space) or intangible (such as selling the right to use copyrighted material), revenues should be recognized over time or as the assets are used—keeping in line with the concept of an exchange transaction.

## **Credit arrangements**

If a sale is made on credit, or through trade receivables, revenues are typically recognized at the point the customer takes ownership of the product, or the service is delivered. The uncertainty inherent in such sales can be accounted for through a provision for bad debt, which is charged against sales for the period concerned.

Some types of credit sale put the seller at increased risk—for example, if a customer pays through a series of installments over an extended period. In this case, a contract is established that only transfers legal ownership once all the payments have been made—even though the product has already been delivered. This gives the seller the right to repossess goods if a customer defaults on payments. Contracts of this kind are often seen in the sale of farm machinery or high-value items of furniture, to protect the seller against the risk of writing off significant sums. Such sales can be recorded in two ways. The “installment sales method” defers recognition of gross profits until the customer has paid. Under the “cost recovery method,” gross profits are recognized once the customer has paid enough to cover the direct costs of the sale.

## What to Avoid

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### **You Recognize Revenues Too Soon**

Managers are often under great pressure to meet revenue targets—whether from the company's investors, plans for development or competitors in the same sector. It's tempting therefore to recognize revenues before they are earned and realizable. However, such aggressive accounting practice opens up the risk of lawsuits by sellers, investors and financiers. Managers are therefore well advised to scrutinize the transactions that occur, and how the recognition of revenues is handled for each different type, with the help of a certified public accountant or the company's auditors. If there are any outstanding issues, the company's audit committee should perform an analysis of its revenue recognition policies and procedures.

### **You Use an Inappropriate Method**

Sometimes it's not obvious which revenue recognition method is best for a particular transaction. In such cases, it's useful to look at approaches by other companies in the sector, and to use the method most commonly adopted in similar situations. This means that a company's results will be comparable with those of its competitors, and helps ensure that revenue is recognized in a consistent manner over time.

## Where to Learn More

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### **Web Site:**

U.S. Securities and Exchange Commission: [www.sec.gov](http://www.sec.gov)