14. Basic Elements of Revenue Recognition

To recognize an item is to record it into the accounting records. Revenue recognition normally occurs at the time services are rendered or when goods are sold and delivered to a customer. The basic conditions of revenue recognition are to look for both (a) an exchange transaction, and (b) the earnings process being complete.

For a manufactured product, should revenue be recognized when the item rolls off of the assembly line? The answer is no! Although production may be complete, the product has not been sold in an exchange transaction. Both conditions must be met. In the alternative, if a customer ordered a product that was to be produced, would revenue be recognized at the time of the order? Again, the answer is no! For revenue to be recognized, the product must be manufactured and delivered. Modern business transactions frequently involve complex terms, bundled items (e.g., a cell phone with a service contract), intangibles (e.g. a software user license), order routing (e.g., an online retailer may route an order to the manufacturer for direct shipment), and so forth. It is no wonder that many “accounting failures” involve misapplication of revenue recognition concepts. The USA Securities and Exchange Commission has additional guidance, noting that revenue recognition would normally be appropriate only when there is persuasive evidence of an arrangement, delivery has occurred (or services rendered), the seller’s price is fixed or determinable, and collectability is reasonably assured.

14.1 Payment and Revenue Recognition

It is important to note that receiving payment is not a criterion for initial revenue recognition. Revenues are recognized at the point of sale, whether that sale is for cash or a receivable. Recall the earlier definition of revenue (inflows and enhancements from delivery of goods and services), noting that it contemplates something more than simply reflecting cash receipts. Also recall the study of journal entries from Chapter 2; specifically, you learned to record revenues on account. Much business activity is conducted on credit, and severe misrepresentations of income could result if the focus was simply on cash receipts. To be sure, if collection of a sale was in doubt, allowances would be made in the accounting records. When you study the chapter on accounts receivable you will see how to deal with these issues.