

Chapter 6  
Revenue Recognition  
Part 1 – General  
Approach

Intermediate Accounting I  
Dr. Chula King

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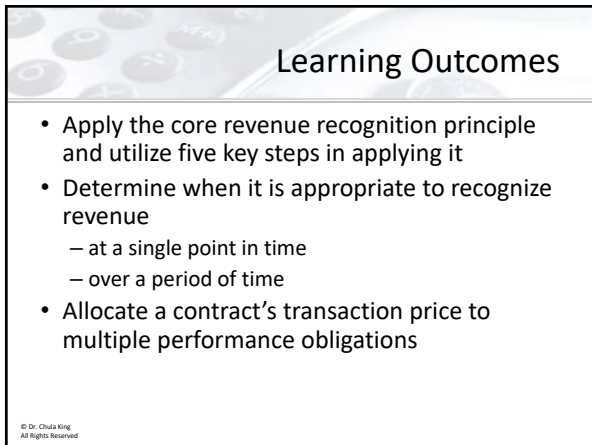
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Learning Outcomes

- Apply the core revenue recognition principle and utilize five key steps in applying it
- Determine when it is appropriate to recognize revenue
  - at a single point in time
  - over a period of time
- Allocate a contract’s transaction price to multiple performance obligations

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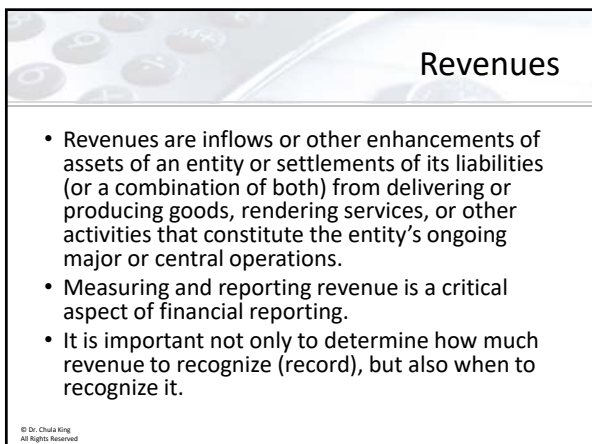
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Revenues

- Revenues are 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.
- Measuring and reporting revenue is a critical aspect of financial reporting.
- It is important not only to determine how much revenue to recognize (record), but also when to recognize it.

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## 5 Steps to Revenue Recognition

1. Identify the contract.
2. Identify the performance obligation(s).
3. Determine the transaction price.
4. Allocate the transaction price.
5. Recognize revenue when (or as) each performance obligation is satisfied.

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## Recognition at Single Point in Time

- Control of goods or services is transferred from seller to customer
- Control demonstrated if customer has
  - Obligation to pay seller
  - Legal title to asset
  - Physical possession of asset
  - Assumed risks and rewards of ownership
  - Accepted the asset

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## For Example

TrueTech Industries sells the Tri-Box, a gaming console that allows users to play video games individually or in multiplayer environments over the Internet. A Tri-Box is only a gaming module and includes no other goods or services. When should TrueTech recognize revenue for the following sale of 1,000 Tri-Boxes to CompStores?

December 20, 2020: CompStores orders 1,000 Tri-Boxes at a price of \$240 each, promising payment within 30 days after delivery.

No Entry

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**For Example (continued)**

January 1, 2021: TrueTech delivers 1,000 Tri-Boxes to CompStores, and title to the Tri-Boxes transfers to CompStores.

Accounts receivable (\$240 x 1,000)	240,000
Sales revenue	240,000

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**For Example (continued)**

January 1, 2021: TrueTech delivers 1,000 Tri-Boxes to CompStores, and title to the Tri-Boxes transfers to CompStores.

Accounts receivable (\$240 x 1,000)	240,000
Sales revenue	240,000

January 25, 2021: TrueTech receives \$240,000 from CompStores.

Cash	240,000
Accounts receivable	240,000

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**Recognition over Period of Time**

- Revenue is recognized over a period of time if any of following three criteria is met:
  - The customer consumes the benefit of the seller's work as it is performed (example: a cleaning service).
  - The customer controls the asset as it is created (example: constructing a building extension).
  - The seller is creating an asset that has no alternative use to the seller and the seller has the legal right to receive payment for progress to date (example: an order of jets customized for the U.S. Air Force).
- Revenue is recognized in proportion to the amount of performance obligation that has been satisfied

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### For Example

TrueTech Industries sells one-year subscriptions to the Tri-Net multiuser platform of Internet-based games. TrueTech sells 1,000 subscriptions for \$60 each on January 1, 2021.

Cash (\$60 x 1,000)	60,000
Deferred revenue	60,000

At the end of each of the 12 months following the sale, TrueTech would record the following entry to recognize Tri-Net subscription revenue:

Deferred revenue (60,000 ÷ 12)	5,000	
Service revenue		5,000

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### When None of the Three Criteria Apply

If a performance obligation doesn't meet any of the three criteria for recognizing revenue over time:

- Recognize revenue at the point in time when the performance obligation has been completely satisfied.
- Usually occurs at the end of the contract.

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### Determining Progress Toward Completion

To recognize revenue over time, a seller needs to estimate progress towards completion.

Output-based estimate:

- Measured as the proportion of the goods or services transferred to date.

Input-based estimate:

- Measured as the proportion of effort expended thus far relative to the total effort expected to satisfy the performance obligation.

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## Contracts Containing Multiple Performance Obligations

If we suspect a contract has multiple performance obligations, steps 2 and 4 of the revenue recognition process come into play.

- Step 1: Identify the contract.
- **Step 2: Identify the performance obligation(s).**
- Step 3: Determine the transaction price.
- **Step 4: Allocate the transaction price to each performance obligation.**
- Step 5: Recognize revenue when (or as) each performance obligation is satisfied.

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## Identify Performance Obligation(s)

Sellers account for a promise to provide a good or service as a performance obligation if the good or service is distinct from other goods or services in the contract.

- A good or service is distinct if it is both:
  1. Capable of being distinct.
  2. Separately identifiable from other goods or services in the contract.
    - Example of failing the “separately identifiable” criterion: Construction contracts.

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## For Example

TrueTech Industries manufactures the Tri-Box System, a multiplayer gaming system allowing players to compete with each other over the Internet.

- The Tri-Box System includes the physical Tri-Box module as well as a one-year subscription to the Tri-Net multiuser platform of Internet-based games and other applications.
- TrueTech sells individual one-year subscriptions to the Tri-Net platform for \$60. Customers can access the Tri-Net using a Tri-Box as well as other gaming modules.
- TrueTech sells individual Tri-Box modules for \$240. Customers can use a Tri-Box to access the Tri-Net as well as other multiuser gaming platforms.
- As a package deal, TrueTech sells the Tri-Box System (module plus subscription) for \$250.

On January 1, 2021, TrueTech delivers 1,000 Tri-Box Systems to CompStores for \$250 per system and receives \$250,000 from CompStores on January 25, 2021.

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## Are the Goods and Services Distinct?

Step 1: Identify the contract: Yes.

Step 2: Identify the performance obligation(s).

- A good or service is distinct if it is both:
  - Capable of being distinct.
  - Separately identifiable from other goods or services in the contract.

A Tri-Box System contains two distinct goods and services:

- Tri-Box module.
- Tri-Net subscription.

Therefore, a Tri-Box System includes two performance obligations.

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## Step 3: Transaction Price Determination

- Transaction price =  
\$250 per system x 1,000 systems = \$250,000

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## Step 4: Allocation of Transaction Price

- The transaction price of one Tri-Box System is \$250.
- The stand-alone price of a Tri-Box module is \$240.
- The stand-alone price of a Tri-Net subscription is \$60.
- Tri-Box Module:  $\$240 \div (\$240 + \$60) = 80\% \times \$250 = \$200/\text{module}$
- Tri-Net Subscriptions:  $\$60 \div (\$240 + \$60) = 20\% \times \$250 = \$50/\text{system}$

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## Step 5: Recognizing Revenue

Accounts receivable	250,000	
Sales revenue (80% x \$250,000)		200,000
Deferred revenue (20% x \$250,000)		50,000

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## Summary of Fundamental Revenue Recognition Issues

- 1. Identify the contract**  
A contract establishes the legal rights and obligations of the seller and customer with respect to one or more performance obligations.
- 2. Identify the performance obligation(s)**  
A performance obligation is a promise to transfer a good or service that is distinct, which is the case if the good or service is both (a) capable of being distinct and (b) separately identifiable.
- 3. Determine the transaction price**  
The transaction price is the amount the seller is entitled to receive from the customer.
- 4. Allocate the transaction price**  
The seller allocates the transaction price to performance obligations based on the relative stand-alone selling prices of the goods or services in each performance obligation.
- 5. Recognize revenue when (or as) each performance obligation is satisfied**  
The seller recognizes revenue at a **single point in time** when control passes to the customer, which is more likely if the customer has:
  - Obligation to pay the seller
  - Legal title to the asset
  - Possession of the asset
  - Assumed the risks and rewards of ownership
  - Accepted the assetThe seller recognizes revenue over a **period of time** if:
  - Customer consumes benefit as work performed,
  - Customer controls asset as it's created, or
  - Seller is creating an asset that has no alternative use to the seller and the seller has right to receive payment for work completed

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## The Next Step

- Part 2: Special Issues in Revenue Recognition
- Part 3: Accounting for Long-Term Contracts

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