Recording Revenue

In business accounting, as in personal accounting, accrual-based accounting is used to record transactions. Revenues are recorded or recognized when they are earned regardless of when cash payment is received from the customer. Cash received for selling services or products is a timing issue, and cash for revenue can be received from customers at three different times.

1. Received before services are performed
2. Received when services are performed
3. Received after services are performed

In all cases, equity will increase when revenue is recognized.

Cash Received before the Service is Performed

When a customer pays a business for services before they are performed, it is known as a **customer deposit**. A number of different types of businesses require deposits or prepayments for their services. Examples include banquet halls (hall rental fees), health clubs (memberships), magazine publishers (subscription dues) and insurance companies (insurance premiums). In each case, the business receives cash up front and provides a service at a later date.

Since services have not been performed at the time the cash is received, service revenue cannot be affected. Instead, the business has an obligation to provide services in the future. You will recall that an obligation of a business is a liability. Thus, a new liability account known as unearned revenue must be used.

Receive prepayment from customer

BALANCE SHEET	
ASSETS	LIABILITIES
CASH + $1,100	ACCOUNTS PAYABLE
ACCOUNTS RECEIVABLE	UNEARNED REVENUE + $1,100
OFFICE SUPPLIES	BANK LOAN
PREPAID EXPENSES	OWNER'S EQUITY
	OWNER'S CAPITAL
PROPERTY, PLANT & EQUIPMENT	OWNER'S DRAWINGS

No change in owner's equity

FIGURE 2.9

Suppose a business receives a deposit of $1,100 from a customer one month before services must be provided. Figure 2.9 illustrates the impact on the accounts of the business at the time the customer paid for the services (one month in advance). The prepayment by the customer is a liability for the business (unearned revenue) because the business now has an obligation to provide services to the customer. The payment is essentially held in trust on behalf of the customer. At this point, there is no impact on equity because even though cash is received, revenue is not recognized since no work has been completed. If the business fails to provide the services, they must return the deposit to the customer.

It is only when work is completed in the next month that revenue can be recognized. The transaction to record this will be covered in a later chapter.

Cash Received when the Service is Performed

When a company performs a service and the customer pays for it immediately, the transaction is fairly straightforward. From the service provider's perspective, cash increases and equity increases. The increase in equity is recognized as revenue and increases net income.

If a client pays $1,100 cash immediately when the business provides the service, then cash and service revenue will be affected. The impact on cash and service revenue is shown in Figure 2.10. Remember that recognizing revenue results in an increase to equity.

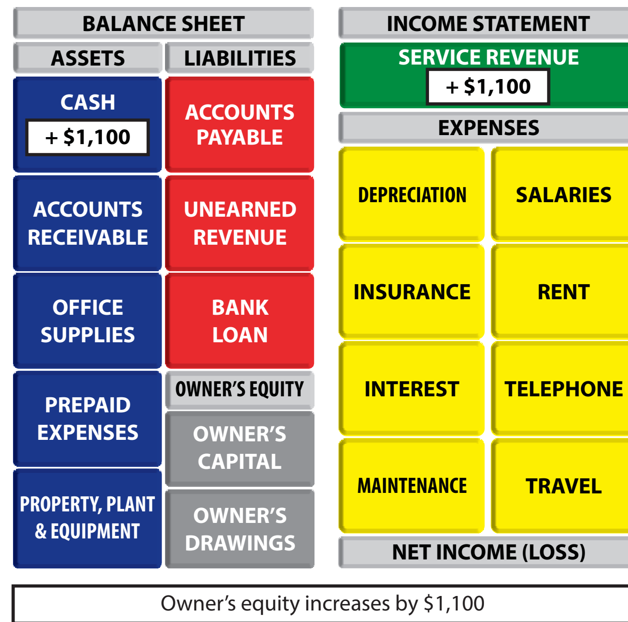

FIGURE 2.10

Cash Received after the Service is Performed

Most businesses provide customers with payment terms which allow customers to pay after they have received the product or service (e.g. 30 days to pay the balance owing). This form of making sales is sometimes referred to as "selling on account." You may mistakenly think that the value of equity would not change when selling with payment terms because no cash was received from the sale. However, revenue must be recorded at the time the product is sold or the service is delivered, regardless of when the payment is received.

When a company provides payment terms to sell its products or services, the money owed by its customers is recorded as an asset, called accounts receivable. After a service is provided, the seller issues an **invoice** to the buyer. The invoice includes the details of the service rendered and the agreed-upon price. This indicates that the customer now owes the balance and needs to pay the seller by the date stated on the invoice. From the seller's perspective, this indicates an increase in accounts receivable (an asset) and an increase in equity (recognized as revenue). Later, when the customer actually pays the outstanding amount, the issuing company increases cash and decreases accounts receivable. The

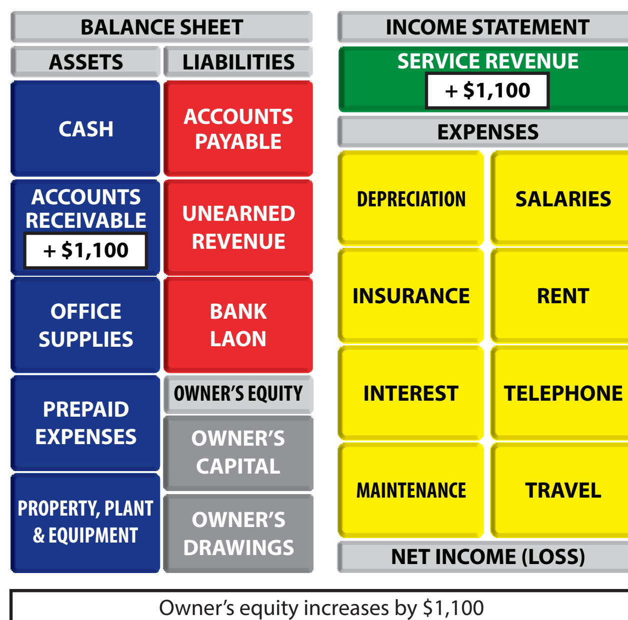

FIGURE 2.11