Rockefeller College
of Public Affairs & Policy
University at Albany State University of New York

Department of Public Administration & Policy
albany.edu/rockefeller

Module 5 Revenues, Expenses, and Activity Statement

PAD 501

Gang Chen

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Overview

- Required Reading: Chapter 10
- Understand the definitions of these concepts:
  - Activity Statement
  - Cash-flow Statement
  - Revenues and support
  - Expenses
  - Net income
- Understand these skills:
  - How to record transactions in balance sheet and activity statement
  - How to generate basic balance sheet and activity statement for an organization

The Activity and Cash-Flow Statements

- The Activity Statement
  - Shows an entity's cumulative revenue and support to its expenses for any period of time—such as a fiscal year.
  - Shows whether the organization was able to cover its costs.
- Other names for Activity Statement: Income Statement, Operating Statement, Statement of Revenues and Expenses, or Profit and Loss (P&L) Statement.
- The Cash-Flow Statement looks at where an entity obtained its cash and where it spent cash during some time period.

So…What is a revenue?

- Tuition revenue for a university?
- Ticket sales for a theater?
- Consulting fees for a firm?
- Property tax for a government?
- Federal aid for an organization?
- Membership fees for a museum?
- Donations to a nonprofit?

- These are all revenues OR support.

Revenues and Support

- Revenues and Support:
  - Represent inflows that the organization has received or is entitled to receive.
  - Result in an inflow of Assets to the organization and an increase in Net Assets.
- Revenues are generally the result of an exchange for goods and services that the organization has provided.
- Support is the result of gifts, grants, and other contributions to the organization.
- Remember: Revenues and support INCREASE an organization's net assets

Recognizing Revenue and Support

- Revenue is recognized if:
  - The goods or services have been provided to the customer,
  - The amount to be collected can be objectively measured, and
  - There is a reasonable likelihood of collection.
- Support is recognized if:
  - All of the conditions of the gift have been met,
  - The value of the pledge can be objectively measured, and
  - There is a reasonable likelihood of collection.

Examples

- When a university provides a semester of classes and sends out tuition bills to students — should that tuition be recognized as revenue?
  - Yes, because the service has been provided, the amount is measurable, and the university expects to collect the payment
- When a nonprofit that receives a grant but still has to meet certain reporting or performance conditions before using the funds — should that be recognized as support?
  - No, support is not recognized until those conditions are met.
- When a donor pledges to contribute ten thousand dollars to an organization, but it's uncertain whether the donor can actually pay — should the organization record that as revenue?
  - No, the organization will wait to record that as revenue or support until collection becomes reasonably certain
- We will practice how to recognize revenues and support in the example video.

And…What is an expense?

- Salaries for employees?
- Rent for office space?
- Utilities for the building?
- Supplies or materials used for operations?
- Insurance premiums?
- Interest on loan?
- Depreciation of buildings and equipment?

- These are all *expenses* — the outflows of assets used to support an organization's operations or generate revenue and support.

Expenses and Net Income

- Expenses:
  - Represent the recognition of the use of an asset to generate revenue and support or otherwise carry on the operations of the entity.
  - Result in an outflow of assets and a **decrease in Net Assets**.
- Net Income is the difference between revenues and support and expenses.
  - Profits are an excess of revenues over expenses. Also called a surplus or increase in net assets.
  - Losses are an excess of expenses over revenues. Also called a deficit or decrease in net assets.
- Revenues, expenses, and net income are three main components of an activity statement.

Recognizing Expenses

- Expense Recognition depends on the type of expense:
  - Product costs are those directly connected to providing goods and services. They are recognized:
    - based on the matching principle, which holds that expenses should be recorded in the same period as the revenue they were used to generate.
  - Period Costs, such as rent, are those related to the passage of time. They are recognized:
    - in the time period they are incurred.

Examples of expense recognition

- Salaries for employees
  - Recognize when employees have performed their work, even if the salary is paid later
- Rent for office space
  - Recognize as time passes during the rental period, even if rent is paid in advance.
- Utilities for the building
  - Recognize when the utility service is used — when electricity or water has been consumed.
- Supplies or materials used for operations
  - Recognize when the supplies or materials are actually used, not when they are purchased.
- Insurance premiums
  - Recognize over the coverage period — as time passes and the insurance protection is used.
- Interest on loan
  - Recognize as time passes and interest accumulates on the outstanding loan balance.

Recognizing Revenue and Expense in a Sales Cycle

- When goods or services are provided, and the invoice is issued (customers haven't paid yet)
  - Recognize revenue — because the organization has delivered the goods or services and earned the right to payment.
  - Recognize expense — for the cost of materials or other resources used to produce the goods or services.
  - Record accounts receivable (asset) and revenue — the organization now has a legal claim to collect payment.
- When the customer pays:
  - Record cash increase and reduce accounts receivable — this is the collection, not the revenue.
- If the sales are made and cash is paid at the same time:
  - Cash goes up; revenue goes up; material and resources, if any, go down; expense recognized.
- If payment is received in advance:
  - Record cash increase and deferred revenue (liability) — revenue will be recognized later when the goods or services are provided.

Recognizing support in a donation cycle

- When a pledge is made (donor promises a future donation):
  - Record pledge receivable (asset) and support revenue only if the pledge is unconditional, measurable, and collection is likely.
  - If the pledge has conditions, do not recognize support until those conditions are met.
- When the donation is received in cash:
  - Record cash increase and reduce pledge receivable — this is the collection of support already recognized.
- If the donation is made in cash:
  - Cash goes up; Donation revenue goes up.
- What if the donation is conditional or restricted? We will discuss this in the next module.

What if you expect some of the invoice is not paid? …Bad debt Expense

- When recognizing revenues:
  - Record Accounts Receivable ($100) — the amount customers owe.
  - Record Allowance for Uncollectible Accounts (-$10) — an estimate of what may not be collected.
  - Accounts Receivable, net = $90 (the expected collectible amount).
  - Record Revenue ($100).
  - Record Bad Debt Expense ($10) — recognizing the estimated uncollectible portion as an expense in the same period as the revenue.

How to recognize expenses associated with capital assets? …Depreciation Expense

- Depreciation expense represents the current periods' share of the cost of using a capital asset over its life.
  - This illustrates the matching principal.
  - Depreciation expenses may be calculated either on a straight-line or an accelerated basis.

Straight-Line Depreciation Example

Cost of a van	$32,000
Less: Salvage (Residual) Value	2,000
Depreciable Amount	$30,000
÷ Useful life	5 years
Depreciation Expense per year	$ 6,000

(You will recognize this expense for the van every year)

Inventory Expense

- Inventory expenses represent the cost of using supplies to create goods or services. Inventory expense and the ending inventory value are calculated using the following relationship:

Beginning Inventory	+	Purchases	-	Consumption	=	Ending
5	+	10	-	???	=	2

- LIFO and FIFO inventory flow assumptions. FIFO (first-in, first-out) assumes that the oldest items are used first, so ending inventory reflects more recent costs. LIFO (last-in, first-out) assumes the newest items are used first, so ending inventory reflects older costs.

FIFO (First in First out) and LIFO (Last in First out)

- Suppose that the Big City public health clinic started the year with 2,000 vials of methadone for its drug rehab clinic. They cost $10 each. During the year the clinic bought 3,000 more vials for $15 each. If they had 1,000 left at the end of the year, what was their inventory expense and how much was the remaining inventory worth?
- 2,000 vials ($10) + 3,000 ($15) vials - ??? vials = 1,000 vials

Inventory Method	Beginning Balance	Purchases	Consumption (Inventory Expense)	Ending Balance
LIFO	$20,000	$45,000	3,000 x $15 +1,000 x $10 =$55,000	$10,000
FIFO	$20,000	$45,000	2,000 x $10 +2,000 x $15 = $50,000	$15,000

Prepaid and Deferred Revenue

- Prepaid occurs when an organization pays for its expenses ahead of time. Prepaids are recognized as asset changes (cash goes down and prepaid goes up). Prepaid will not affect expenses or net assets.

- Deferred or unearned revenues arise when an organization receives revenues in advance for goods or services. Deferred usually is long term, and unearned usually is short term. Deferred or unearned revenues will not affect revenues or net assets. Deferred or unearned revenues will be recognized as changes in assets and liabilities (cash goes up and liabilities go up)

- Why is deferred revenue a liability to an organization?

Examples for prepaid and deferred revenues

- An organization pays $12,000 in January for a one-year insurance policy.
  - Record as Prepaid Insurance (Asset) when paid. (Cash goes down; prepaid goes up)
  - Each month, recognize $1,000 as Insurance Expense as coverage is used. (Prepaid goes down; expense decreases net assets)
- A theater sells season tickets in advance of the performances.
  - Record as Deferred Revenue (Liability) when cash is received. (Cash goes up; deferred revenue goes up)
  - Recognize Revenue as each show is performed. (Deferred revenue goes down; revenue goes up)
- A university collects **tuition before classes begin**.
  - Record as *Deferred Tuition Revenue* until the semester starts. (Cash goes up; deferred revenue goes up)
  - Recognize Revenue as semester is done. (Deferred revenue goes down; revenue goes up)

Where the Income Statement and Balance Sheet Meet

	Event	Statement Impact	Note
Revenue Recognized	You provide a good or service and earn revenue	AR or Cash up B/S Revenue up A/S	AR is a "holding area" for unpaid bills that you have sent out
	Someone pays a bill you sent	AR down B/S Cash up B/S	
	When you buy something	AP up or Cash down B/S Inventory up B/S	AP is where you keep track of what you owe to others
Expense Recognized	When you use something	Asset down or Liability up B/S Expense up A/S	

B/S stands for the Balance Sheet, and A/S stands for Activity Statement.
AR is Account Receivable; AP is Account Payable

Reflecting the Change in Net Assets on the Balance Sheet

Net income is reported as a change in net assets on the balance sheet.

Total Revenue and Support	$81,000
Total Expenses	- 80,050
Increase in Net Assets	$ 950

← Activity Statement

Balance Sheet

	Unrestricted	Temp. Rest.	Perm. Rest.
Beginning Balances	$113,000	$15,000	$10,000
Increase in Net Assets	950		
Ending Balances	$113,950	$15,000	$10,000

The Cash-Flow Statement

- The Statement of Cash Flows focuses on the sources and uses of cash for the organization. It divides those cash flows into:
  - Operating: Activities related to accomplishing the organization's primary mission.
  - Investing: Buying or selling long-term fixed assets and investments.
  - Financing: borrowing and repaying loans.

- Why does an organization need both an operating statement and a cash-flow statement?
- Why is it important to know the sources and uses of cash flow?
  - An organization can show a surplus on paper but still run out of cash