15.514 Summer 2003

SESSION 5
REVENUE RECOGNITION

Objectives
1. Reinforce and extend your understanding of revenue recognition.
2. Illustrate how accounting numbers can influence the operating decisions they reflect.

Reading Assignment
   CP: *Circuit City Stores, Inc. (A)*

Class Preparation Questions
   In addition to the two questions at the back of Circuit Cities (CC), answer the following:

1. Show the BSE (Balance Sheet Equation) effects of the following events under the 3 accounting alternatives described on pp. 2 and 3.
   - On 1/1/90, CC sells a stereo for $1,000 cash. Cost of inventory is $900. Customer also pays $100 cash for 2-year warranty coverage, which CC expects to require $20 in parts and labor over that period (through 12/31/91).
   - 12/90, the customer brings the stereo in for inspection. Actual cost to CC is $8.
   - 12/91, the customer brings the stereo in again; actual cost to CC is $15.

2. Compare yearly and total Net Income (i.e., for 1990 + 1991) of the scenario posed above under the three accounting treatments.
3. How will Circuit City's financial statements be affected if the FASB requires them to change the accounting treatment for extended warranty and product maintenance contracts? What additional information or assumptions would you need to estimate the dollar impact of this change?
4. As a user (lender, investor) of CC's financial statements, how would you prefer they account for extended warranty contracts? Why?

Graded Assignment
        Problem Set 2 – Circuit City

Optional Problems
        See Session 4