Installment Sales

Installment sales: recognize revenue when cash is collected—not sale
  o No accrual: gross profit deferred until collection
    ▪ Sales less cost of goods sold= gross profit
    ▪ Find rate of gross profit and apply to cash collections
      • Rate = Gross profit / Total sale
    ▪ Rate x Gross profit = amount of profit to recognize on the income statement and defer to future years gross profit not realized (in a deferred gross profit account)
    ▪ Keep installment sales separate from other sales
  o Seller is protected: title does not pass until all payments are made
  o Justification for an installment sale: risk of not collecting accounts receivable is great enough that sale of the good or service is not evidence that revenue should be recognized now–only when cash is collected
  o Front end loading is the opposite: this is to recognize revenue prematurely
  o FASB prescribes installment sale method for real estate – the title passes when the “mortgage is burned” (i.e.- no more payments)
  o Repossession may occur if installment sale is deemed uncollectible
    ▪ Write off receivable with the attached deferred gross profit
    ▪ JE: Repossessed merchandise xxx
      Deferred gross profit xxx
      Installment A/R xxx
    ▪ Asset should be acquired at fair value
  o Deferred gross profit on installment sales is an unearned revenue
    ▪ Unearned revenue is a quasi-liability
    ▪ Three elements that compose deferred gross profit:
      • Income tax liability
      • Collection expense
      • Net income

Cost-recovery method of revenue recognition
  • No profit recognized until the cash payments by buyer exceed the sellers Cost of Goods Sold

Deposit method
  • Postpone recognizing sale until the sale and asset transfer occurs
  • Seller treats the cash received from buyer is a deposit on a contract, and this is a liability that he owes to the buyer until the actual sale occurs
  • Since the seller has not performed, there is no claim on the deposit