Chapter 4

Income Measurement and Accrual Accounting

Key Concepts:
- What is meant by accrual accounting?
- When is revenue recognized?
- When are expenses recognized?
- How does matching apply to revenue and expenses?
- What are adjusting entries?
- What is the accounting cycle?
Chapter Outline

LO 1  Recognition and Measurement in Financial Statements

Recognition: formal recording in words and numbers of an item in the financial statements

Measurement: quantification in dollars of the effects of economic events

- **Historical cost** is recorded for simplicity, verifiability, reliability
  - *current value* is what could be received for an asset currently
    - only an estimate until item is sold
    - perhaps more relevant, but less reliable

- **Unit of measure** is money
  - inflation affects purchasing power, and thus the stability of this measure

LO 2  The Accrual Basis of Accounting

Basic difference between cash basis and accrual basis is one of timing (Exhibit 4-2).

- **Revenue:**
  - cash basis recognizes revenue when cash is received
  - accrual basis recognizes revenue when it is earned
    - accounts receivable created at time of sale

- **Expense:**
  - cash basis recognizes expense when cash is paid
  - accrual basis recognizes expenses when they are incurred
    - payables created at the time the expense is incurred (i.e. account payable, rent payable, salaries payable, interest payable, taxes payable)

- Accrual basis is necessary because we divide the earning of income, a process that takes place over a period of time, into artificial segments (reporting periods)

Statement of cash flows provides information for an accrual-based company on sources and uses of cash (Exhibit 4-3).

Accrual accounting and time periods

Earning of income takes place over a period of time, not all at one time.

- We divide time into calendar periods

LO 3  The Revenue Recognition Principle

Revenue: increase in assets or decrease in liabilities because of the delivery of goods or services to customers

- Revenue recognition principle
  - realized: goods or services exchanged for cash or promise of cash
  - earned when realization is complete

Other possible interpretations of recognition principle:

- **Percentage-of-completion method:** for a long-term project, revenue is recognized as stages are completed, based on the proportion of total costs incurred
Franchises: revenue is recognized from the sale of the original franchise, plus continuing fees based on performance

Production method (commodities): since commodities are traded at an established price, and the market can absorb all production without any effect on price, revenue can be recognized when the commodities are produced

Installment method: (opposite of production method) in the absence of a reasonable estimate of collectibility, revenue on a sale is recognized as cash is collected

Some revenue, such as rent and interest, is earned continuously

Expense Recognition and the Matching Principle

Expense occurs when an asset has no future benefit—the asset is used up—or a liability is incurred.

Matching principle: associate revenues with the costs (expenses) necessary to generate them

- Sometimes not done with specific items of product sold, but with the period in which products were sold
  - sales clerks' salaries are expensed in the period in which the clerks worked
- For some items the benefit is seen to expire as soon as costs are expended, so they never go through the asset stage
  - utilities costs, telephone, fuel for vehicles are expensed as they are purchased
- For tangible, long-term assets, the cost (depreciation expense) is allocated to the periods to which the asset provides benefits

Exhibit 4-4 shows the relationship among costs, assets, and expenses.

Accrual Accounting and Adjusting Entries

Four types of adjusting entries are made at the end of the accounting period in an accrual-based company.

- Deferred expense: cash paid before the expense is incurred:
  - asset is created
  - as asset expires it becomes an expense, via adjusting entry
    - prepaid rent becomes rent expense, a month at a time
    - depreciation allocates cost of a long-lived asset over its useful life
      - does not measure decline in value
      - straight-line method
      - cost − salvage value ÷ life = periodic expense
      - the life of the asset and the salvage value are estimates
      - depreciation expense reduces the reported profits
      - depreciation reduce assets via a contra asset account—an asset account with a negative—called accumulated depreciation

- Deferred revenue: cash received before revenue is earned
  - liability created because goods or services are still owed
  - "the other company" from the deferred expense entries: for example, the landlord who received the prepaid rent has a deferred revenue
• as the revenue is earned, liability is reduced, revenue increased, via adjusting entry
  ♦ magazine subscriptions received by a publisher in advance, earned as magazines are mailed

- **Accrued liability**: expense incurred before cash is paid
  • opposite of deferred expense
  • taxes, payroll, utilities, interest
  • adjusting entry records expense even though no payment was made
    ♦ interest for short-term loan often paid at maturity with principal
    ♦ \( I = P \times R \times T \) is formula to calculate interest liability at any point in time
      • Interest, Principal, Rate, Time

- **Accrued asset**: revenue is earned before cash is received
  • both rent and interest are earned as time goes by, regardless of when cash is received
  • need adjusting entry if payment is not received

**Alternate terms:**
- **Deferred expense** = prepaid expense = prepaid asset
- **Deferred revenue** = unearned revenue

**The Accounting Cycle**
- **Accounting cycle**: steps taken to collect and record the necessary information to prepare financial statements (Exhibit 4-8)
- **Worksheets**: The accounting cycle may be completed either with or without worksheets. Worksheets are not financial statements but are simply devices to aid the accountant. The steps in the accounting cycle are performed in a slightly different sequence when worksheets are used as is shown below:

  **with a worksheet**
  - collect and analyze data
  - journalize events
  - post to ledger
  - prepare worksheet with adjustments
  - prepare financial statements
  - journalize and post adjustments
  - journalize and post closing entries
  - journalize and post-closing entries
  - post-closing trial balance
  - optional: reversing entries

  **without a worksheet**
  - collect and analyze data
  - journalize events
  - post to ledger
  - journalize and post adjustments
  - prepare financial statements
  - journalize and post closing entries
  - post-closing trial balance
  - optional: reversing entries

**The closing Process**

**Two types of accounts:**
- **Permanent** = balance sheet = real accounts
- **Temporary** = income statement, dividend = nominal accounts
Purpose of closing entries:

- Close temporary accounts (return balances to zero)
- Transfer net income (loss) to retained earnings close, rather than posting actual entries
### Lecture Suggestions

**LO 3**

Revenue recognition is a difficult concept for students to grasp except when a transaction is simply for cash. Spending some additional time on this topic is generally time well spent for helping students to appreciate the effect of transactions on the financial statements. This is especially true when addressing more complex transactions in which revenue recognition may occur over a prolonged period such as in the percentage of completion, franchises, etc.

**LO 5**

Adjusting journal entries, and the terms associated with them, are also difficult for accounting students to master. The concept defies logic as students see it. Use a number of examples, with the "our company" and "the other company" reciprocal relationships to show that one company's asset is another's liability, and one's revenue is the other's expense. Exhibit 4-5 is an excellent summary. Encourage students to make their own version of this exhibit, to test their understanding of it, and use the paper as a reference or study guide as they work more problems. A short quiz before any major exam on this topic helps students see where they still need work on adjustments.

**LO 6**

Connect the concepts learned thus far. Point out that the analysis stage (first step in the accounting cycle) is what students were doing when they put transactions down in accounting equation format. This format in turn helps them decide how to journalize the transaction, using the placement of the elements of the transaction in the accounting equation, and the rules of debit and credit. Posting assigns the pieces of journal entries to T accounts.
Comparing the Cash and Accrual Bases of Accounting

In-class discussion: Income versus cash

In its 1999 Income Statement, Uno’s had net income of $9,800,000. Their Statement of Cash Flows showed a decrease in cash and cash equivalents of $10,112,000. Cash provided by operating activities was $24,964,000. How can a company have net income and a decrease in cash? Why is the net income less than the cash provided by operating activities?

Solution

The difference is explained by the fact that the income statement is reported on the accrual basis, and therefore contains revenue amounts that may not have been realized in cash (that is, they were still in accounts receivable) during the previous accounting period (cash was collected this accounting period) and expenses that required no cash outlay (the most familiar to students are depreciation, and purchases still in accounts payable). However, the total amount of cash collected from customers exceeded the cash paid for cost of goods sold and operating items. Also, cash is received from and used for purposes that are not a part of net income. Uno’s cash provided by operating activities was used for: investing activities - additions to property and equipment and leasehold improvements and for financing activities - principal payments on debt and capital lease obligations and to buy back shares of its own stock (treasury stock).

The Revenue Recognition Principle

In-class discussion: Recognition of revenue from extended warranties

Have you been offered an extended warranty, at extra cost, on a recent purchase? How does the seller account for these revenues? Let’s use an actual company to explore this question.

In their 1998 Annual Report, Dell Computer writes in Note 1:

Salient Revenue Recognition — Sales revenue is recognized at the date of shipment to customers. Provision is made for an estimate of product returns. Revenue from separately priced extended warranty programs is deferred and recognized over the extended warranty period and the related extended warranty costs are recognized as incurred.¹

- Explain in your own words why sales of products and sales of warranty programs are accounted for differently.
- What are the “related extended warranty costs” that Dell refers to? Could they be accounted for differently?

Solution

Product sales are generally recognized when the product is delivered, especially in the case where products are being delivered to commercial customers with established credit, whose payment is reasonably assured.

Warranty programs, on the other hand, are a service. This service is available throughout the period specified in each contract, if and when the customer needs it. That may be never. Thus the revenue must be distributed over this period.

Costs are the expenses incurred to repair or replace defective products covered by the warranties. The future costs could be estimated and accrued over the life of the warranties. Dell’s choosing to expense them in the period incurred matches the required tax treatment of warranty costs.

**In-class discussion: New franchises**

An entrepreneur has an idea for a series of photo-developing outlets to be located in high-traffic areas like shopping centers. Customers drop off film for quick, attractively priced, convenient service. The outlets will be franchised to operators in the local areas. The entrepreneur has “scouted” potential locations in a general way, and is now offering franchises. In addition to granting the franchisee the right to operate under the company logo, the franchise fee commits the parent company to help the franchisee find a specific location, build the required “booth,” and train the franchisee/operator. The franchisees must purchase all supplies and equipment from the parent company (franchisor). Franchisees are also required to pay a specified portion of their profits to the parent company.

- How should revenue generated from the initial franchise fees be recognized?
- Are the supplies a revenue item for the parent company?
- How should revenues from the percentage of profits be recognized?
- Suppose the contract clause that requires the franchisee to pay the franchisor a percentage of profits also specifies a minimum amount to be paid in the event of very small profits, or a loss. How would the franchisor recognize these payments? Are they revenue for the *franchisor*, even if the franchisee did not make a profit?
- Would you change any of your answers if you knew that the company was still owed all or part of the franchise fee? In other words, if the contract is signed, and location and training arrangements are moving ahead, but the franchise fee has not been paid to the franchisor, would you account for anything else differently?
- If the franchise agreement allows the initial fee to be refunded under certain circumstances, does this affect the recognition of revenue? Explain your answer.

**Solution**

This question is based roughly on the Fotomat IPO. It raised some very complicated revenue recognition issues the students might enjoy sorting through. Making it a hypothetical company without the actual name avoids side issues based on knowledge of the company. The recognition of franchise revenues is actually covered rather specifically by FASB, but students should use the basic revenue recognition principles they have learned to draw their own conclusions, not research the rules. The rules could be used as a follow-up discussion, time permitting, to demonstrate the logic behind the evolution of accounting standards.

- If at the time the initial fee is paid no specific location for operation exists, other than a general geographic area, then the company has not provided substantial service to the franchisee, and cannot claim to have earned revenue. Once the company and the franchisee have found a location, and begun construction, some—by no means all—of the revenue has been earned, based on the “percentage of completion” concept. Specific details of the “training,” such as what the company will provide, and over how long a period, will govern how quickly this portion of the fee can be recognized.
- Sales of supplies and equipment to franchisees, if these sales generate a profit, do not appear to be tied to the franchise fee, and are revenues when the supplies are delivered.
- The profit-sharing payments are recognized as revenue when they are received, since they require nothing in return from the franchisor.
- If the franchisee is required to remit a minimum amount to the franchisor whether or not a profit is earned, the remittance is income for the franchisor, and an expense for the franchisee.
- If the franchisor has not received the initial fee, the most important question is no longer *when* the fee is earned, but *whether* it is collectable. If the parent company has no doubt that the fee will be collected and the contract will go forward, then it recognizes revenue, depending on when earned, like any other account receivable. However any
doubt about collection introduces a new wrinkle. Logic dictates a delay in recognition of this revenue. The stage of development of the particular franchise will be important to know. Students might well question how far the franchisor should go ahead with developing the location if the prospective franchisee had not yet paid.

- Refundability of the fee casts additional doubt on the agreement. Students will probably speculate on the likelihood of this at various stages of the process, and will agree that an amount must be reserved against this possibility. Varying levels of conservatism are possible, from those who think that once a franchisee has signed a contract they will almost certainly go ahead, to those at the opposite end who won't recognize any revenue at all until the franchise is actually open for business. A middle ground can be found to make a reasonable allowance for refundable fees without delaying the recognition of revenue indefinitely.

**In-class discussion: When is a sale a sale?**

In an article concerning troubled MiniScribe Corp.\(^2\) it was stated that

"…the company 'dramatically' increased shipments to three warehouses, booking $56.4 million in sales and gross profit of $5.4 million."

![Note: the warehouses belonged to MiniScribe.]

What is MiniScribe doing wrong? Is the dollar amount the problem? Is the problem the destination of the shipments (warehouses)? How should the company have recorded these shipments?

**Solution**

The volume of the shipments only called attention to the real problem. Be certain that everyone in the class understands that these were MiniScribe's warehouses, not a customer's. Shipping goods to one's own warehouse is not a sale, but a relocation of inventory. Until a firm order is shipped to a customer outside the company, no revenue is recorded. MiniScribe was charged with fraud for a number of activities, of which this was only one.

**Outside assignment: Revenue recognition methods**

Find a newspaper or magazine article that illustrates each of the methods of revenue recognition listed in the textbook: time of sale, percentage-of-completion, franchises, production, installment, rent and interest. (Ask librarians about on-line research tools.) Explain the method you believe the company in each article uses, and why. Explain how a typical revenue transaction would look, how the company would record it, and when.

**Solution**

This assignment combines practical application of textbook principles, research, reading, and some writing. The project might be assigned to teams, or separated so that each student, or team, will research only one revenue recognition method to reduce the work involved. Everyone is given an opportunity to think about revenue recognition in real-world terms. Enough articles are available to limit the assignment, for example, to articles published within the last year, or even six months, if the assignment is used in back-to-back semesters.

**Expense Recognition and the Matching Principle**

**Outside assignment: Expense versus asset**

Dell computer in their 1998 Annual Report lists "Research, development and engineering" of $204,000,000 as operating expenses on the Income Statement. Dell's total operating expenses were $204,000,000.

\(^2\)The Wall Street Journal, Tuesday, September 12, 1989, "MiniScribe's Investigators Determine That 'Massive Fraud' Was Perpetrated".
$1,406,000,000. Thus, research, development, and engineering represents 14.5% of total operating expenses.

- Define in your own words an asset and an expense.
- Won’t research and development produce future benefit for Dell? Why are they expensing this in the current year, instead of listing it on the balance sheet as an asset?
- If they classify research and development as an asset and amortize it over a number of years, how will they determine the number of years to use?
- Do you think Dell’s Balance Sheet has an asset called “Unexpired research and development costs”? If it does not, doesn’t recognizing a major expense in one year put Dell at an unfair disadvantage compared to other companies? Would you expect to find a similar item on the income statements of other companies? What kinds of companies would they be?

**Solution**

- An expense is an item whose usefulness to the company is complete. An asset will produce benefits in the future.
- Those familiar with the Financial Accounting Standards know that Dell expenses research and development because FASB requires them to do so. Students need not be aware of this regulation. They can decide logically why expensing R & D might be better than calling it an asset. The core of the question is the likelihood that the research will result in future revenue. A secondary question is the life of this future benefit. Since the future benefit is not assured and the life of the benefit is uncertain, the costs are expensed as incurred.
- Some students will be certain that future benefits are produced to give the benefits a finite life. In this question they are forced to measure the life and value of the benefits. The problems of doing so will become obvious.
- There is no “R & D” asset. In terms of the relative disadvantage, students will probably conclude either that (1) if Dell expenses R & D, other similar companies probably also do so, eliminating the comparative disadvantage, or (2) that Dell is having a bad year anyway, so they expense R & D to give them better prospects for the future, or at least a larger tax break. The second reason is not in keeping with the consistency principle. Research and development must be treated in the same way every year. Interestingly R & D is not a separate line item in many of the other statements we’ve looked at. It is likely that product-oriented companies like Ben & Jerry’s or K2 Inc. do have research and development. They probably combine R & D with other administrative expenses. Any company with product development activities, and research-oriented firms like Genentech, a pharmaceutical company, for example, have large expenses in this area.

**In-class discussion: Depreciation expense**

- Upon what estimates is depreciation expense based?
- What prevents a company from manipulating these estimates to achieve a desired increase or decrease in reported income?
- Why is salvage value deducted before periodic expense is calculated? Does this mean that the salvage value is never accounted for? What will eventually happen to the salvage value?
Solution

- Depreciation is based on estimates of the useful life of the asset, and its eventual salvage or resale value.

- A company's asset records, including estimates, will periodically be audited by an independent audit firm. That alone ensures that estimates are consistent. Auditors notwithstanding, most firms do try to develop honest, accurate financial information. The benefits of manipulating these figures are at best short-sighted since eventually, no matter what is done, the entire cost will be written off. Thus, an extra benefit in one year will prove to be a detriment in a future year.

- The company expects to recover the salvage value when the asset is retired, so this salvage value will never be an expense. To include it in the depreciable amount when calculating annual expense would be to overstate expenses over the life of the asset, and overstate profit when the asset is retired, resulting in poor matching. An example with T accounts to prove this is helpful. When the asset's useful life is at an end, the salvage value will be left as the net book value of the asset until the asset is disposed of, whereupon the remaining net book value is written off against the proceeds of the sale to determine the gain or loss, if any, on the disposal.
### Accrual Accounting and Adjusting Entries

**In-class discussion:** These adjustments appear to be trivial amounts

The Balance Sheet for Lincoln Electric Corp. is reproduced below. Which items do you see that may have resulted, at least partially, from adjusting entries? How significant (compared to total assets or total liabilities) are they?

<table>
<thead>
<tr>
<th>($)000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
</tr>
<tr>
<td>Accounts receivable (less allowance of $3,916)</td>
</tr>
<tr>
<td>Inventories</td>
</tr>
<tr>
<td>Raw materials and in-process</td>
</tr>
<tr>
<td>Finished goods</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Deferred income taxes</td>
</tr>
<tr>
<td>Prepaid expenses</td>
</tr>
<tr>
<td>Other current assets</td>
</tr>
<tr>
<td><strong>TOTAL CURRENT ASSETS</strong></td>
</tr>
<tr>
<td><strong>Other assets</strong></td>
</tr>
<tr>
<td>Notes receivable from employees</td>
</tr>
<tr>
<td>Goodwill</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Property, Plant and Equipment</strong></td>
</tr>
<tr>
<td>Land</td>
</tr>
<tr>
<td>Buildings</td>
</tr>
<tr>
<td>Machinery, tools and equipment</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Less allowances for depreciation and amortization</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
</tr>
</tbody>
</table>

| **LIABILITIES AND SHAREHOLDERS’ EQUITY** |
| **Current Liabilities** |
| Trade accounts payable | $ 53,882 |
| Notes payable to banks | 28,541 |
| Salaries, wages and amounts withheld | 17,080 |
| Taxes, including income taxes | 33,160 |
| Dividend payable | 2,988 |
| Current portion of long-term debt | 1,269 |
| Other current liabilities | 31,729 |
| **TOTAL CURRENT LIABILITIES** | **168,649** |
| Long-term debt, less current portion | 93,582 |
| Deferred income taxes | 7,063 |
| Other long-term liabilities | 13,021 |
| Minority interest in subsidiaries | 5,499 |

(continued)
Shareholders’ Equity

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Shares, without par value – at stated capital amount:</td>
<td></td>
</tr>
<tr>
<td>Authorized – 30,000,000 shares;</td>
<td>2,104</td>
</tr>
<tr>
<td>Outstanding – 10,520,987 shares</td>
<td></td>
</tr>
<tr>
<td>Class A Common Shares (non-voting), without par value – at stated capital amount: Authorized – 30,000,000 shares;</td>
<td>2,776</td>
</tr>
<tr>
<td>Outstanding – 13,880,171 shares</td>
<td></td>
</tr>
<tr>
<td>Class B Common Shares, without par value – at stated capital amount: Authorized – 2,000,000 shares; Outstanding – 487,117 shares</td>
<td>97</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>102,652</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>228,555</td>
</tr>
<tr>
<td>Cumulative translation adjustment</td>
<td>(6,238)</td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY</strong></td>
<td><strong>$617,760</strong></td>
</tr>
</tbody>
</table>

**Solution**

Homework examples use small dollar amounts to keep arithmetic to a minimum, so students believe that these entries hardly seem worth the trouble. The accruals and deferrals for a large company provide a sense of proportion to put adjustments into better perspective.

The accounts that students will most likely notice are:

- Deferred income taxes (asset; the liability is also below) results from timing differences between reported income for tax and book purposes. Students may not fully understand this, but will recognize the “deferral” part.
- Prepaid expenses probably contains items such as insurance.
- Other current assets may also contain accruals, such as interest receivable.
- Accumulated depreciation and amortization is the other half of the entry that debits depreciation or amortization expense.
- Salaries, wages and amounts withheld is accrued wages payable, employee benefits and taxes due to the government and benefit providers, at least some of which resulted from adjustments.
- Taxes including income taxes is probably period-end accruals of taxes due.
- Current portion of long-term debt is an adjustment that reclassifies the portion of long-term debt due next year to the current liabilities section.
- Other current liabilities can be more accruals, for example, interest payable.

These items account for about 35% of gross assets and 17% of liabilities. Even allowing that not all the amounts are adjustments, the proportions are still significant. The bad debt allowance was deliberately omitted, since at this stage students are unlikely to know anything at all about it. However it is an adjustment. The minority interest in subsidiaries is also in effect an adjustment resulting from the consolidation process.

**Outside assignment: Unearned revenue for airlines**

American Airlines showed, for 1998, airline group revenues of $17,449 million and total operating revenues of $19,205 million. American recorded on the same year’s Balance Sheet an “Air traffic liability” of $2,163 million.

- What do you think an “Air traffic liability” is? Is the amount significant? When will this liability be retired?
Solution

An “Air traffic liability” is an airline’s unearned revenue from ticket sales. The $2,163 million is approximately 12% of revenues, a significant amount. The simple answer to retirement of the liability is, “when the ticket holders take the trips.” Students may consider, in addition:

- Is revenue earned when the passenger boards? When the plane takes off? When the round trip is complete?
- Is refundability a factor?
- What if the carrier cannot provide the service (strike, snowstorm)?

American’s Footnote 1 to their 1998 Annual Report (Summary of Significant Accounting Policies) reads,

PASSENGER REVENUES Passenger ticket sales are initially recorded as a component of air traffic liability. Revenue derived from ticket sales is recognized at the time transportation is provided. However, due to various factors, including the complex pricing structure and interline agreements throughout the industry, certain amounts are recognized in revenue using estimates regarding both the timing of the revenue recognition and the amount of revenue to be recognized. Actual results could differ from those estimates.\(^3\)

Food for thought: Time Warner Inc. unearned revenue

How do you suppose a company as big as Time Warner keeps track of unearned subscription revenues? They publish many different magazines, including People, Time, Sports Illustrated, Fortune, Teen People, In Style, Parenting, Entertainment Weekly on Campus, Southern Living, Cooking Light, and Weight Watchers. Unearned subscription revenue at the end of 1998 was 741 million.\(^4\) Somewhere in there is your one-year subscription to Time magazine. How do they know how many issues they have sent you? Magazines are sold at a variety of rates, depending on how you subscribe and for how long. This looks like an impossible amount of information for Time Warner to organize. Can they really keep track accurately? Do they have to?

Solution

Since subscription price variations and customer records are all kept by computers, the task is not so difficult as it first seems. Time Warner states in their Footnote 1,

The unearned portion of paid subscriptions is deferred until magazines are delivered to subscribers. Upon each delivery, a proportionate share of the gross subscription price is included in revenues.\(^5\)

The footnote clearly conveys that they can and do closely monitor the process from payment through unearned revenue to delivery and revenue earned. Note the difference between this and the footnote from American Airlines. The airline says that some amounts cannot be recorded precisely and thus to some extent estimates are used. Time Warner does not appear to find this necessary.

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\(^3\)AMR Corp., 1998 Annual Report, Note 1.
\(^5\)op. cit., Note 1.