SECTION – 1

QUESTION-1.

ANSWER:-

Trade Credit:-

Trade credit is an important external source of working capital financing. It is a short-term credit extended by suppliers of goods and services in the normal course of business, to a buyer in order to enhance sales. Trade credit arises when a supplier of goods or services allows customers to pay for goods and services at a later date. Cash is not immediately paid and deferral of payment represents a source of finance.

Features of Trade Credit:

The features of trade credit are given below:

1. There are no formal legal instruments/acknowledgements of debt.

2. It is an internal arrangement between the buyer and seller.

3. It is a spontaneous source of financing.

4. It is an expensive source of finance, if payment is not made within the discount period.

Advantages of Trade Credit:

The advantages of trade credits are

1. It is easy and automatic source of short-term finance.

2. It reduces the capital requirement.

3. It helps the business focus on core activities.

4. It does not require any negotiation or formal agreement.

Disadvantages of Trade Credit:

Like other sources of finance, trade credit is also associated with certain disadvantages, which are as follows:

i. Trade credit is available only to those companies that have a good track record of repayment in the past.

ii. For a new business, it is very difficult to finance working capital through trade credit.

iii. It is very expensive, if payment is not made on the due date.

Accrued Expenses:-

An accrued expense is an accounting term that refers to an expense that is recognized on the books before it has been paid; the expense is recorded in the accounting period in which it is incurred.. Because accrued expenses represent a company's obligation to make future cash payments, they are shown on a company's balance sheet as current liabilities; accrued expenses are also known as accrued liabilities. An accrued expense is only an estimate, and will likely differ from the supplier's invoice that will arrive at a later date.

Example of Accrued Expenses

A company pays its employees' salaries on the first day of the following month for services received in the prior month. So, employees that worked all of November will be paid in December. If on December 31, the company's income statement recognizes only the salary payments that have been made, the accrued expenses from the employees' services for December will be omitted.

Because the company actually incurred 12 months' worth of salary expenses, an adjusting journal entry is recorded at the end of the accounting period for the last month's expense. The adjusting entry will be dated December 31 and will have a debit to the salary expenses account on the income statement and a credit to the salaries payable account on the balance sheet.

Deferred Income.:-

Deferred revenue is payment received for products or services delivered after, not at, the point of purchase. Due to the lag between the purchase and its delivery, deferred revenue is also called unearned revenue.

Why is deferred revenue considered a liability?

Until delivery, it is possible that the service may not be delivered, or that the customer will cancel their order, in which case the money must be returned. Because you have been paid for a good or service that you haven't yet delivered, deferred revenue is a liability. And it's why you will find it listed with other current liabilities on your balance sheet.

To minimize confusion, many SaaS companies use the accrual method for their revenue account. Accrual accounting recognizes revenue only when a transaction is completed, not when payment is received. Revenue recognition only comes about when your company has earned that revenue.

Here's a model graph for keeping account of your revenue: the "cash-in" metric functions as your total deferred revenue. The same amount is recognized every month, and by the end of the year, your cumulative revenue should match that initial cash-in figure.

Example of deferred revenue with a SaaS subscription company

Let's say your company provides anti-malware software via subscription to a growing customer base. Here's how you should go about revenue recognition:

You offer a one-year plan that breaks down into monthly payments of $12.99.

Your customer makes an advance payment for their first year upon subscription. This revenue is deferred until they have received a full year's use of your service.

At the end of every month, you recognize 1/12 of this deferred income, since you have fulfilled your promise to deliver that proportion of your service.

How deferred revenue causes problems for subscription companies

It's tempting to immediately update your income statement when deferred revenue comes in, but here are a few reasons that this approach can be troublesome for a subscription company.

1. Cancellations

Do not ever presume that money in your deferred revenue account can be used for re-investment or paying for overheads; if a customer cancels their subscription, you'll need to return a sum equivalent to the unfulfilled time on their subscription (i.e., nine months' fee, if that's how long they had left on their subscription).

2. Faulty financial predictions

Companies often factor deferred revenue, along with real revenue, into their measures of future revenue growth. However, this can lead to an “illusion of growth:" a deferred revenue balance that sits far higher than an actual revenue balance.

This can mislead investors into believing growth is faster than is really the case. And the longer your invoice period, the higher the risk of overstating your growth potential.

3. Multiple deliverables

If your company provides an instant-access service (online educational courses, for instance) using a subscription model, you will then have to contend with “multiple deliverables.” This means that some of what you are providing is considered fulfilled at purchase, but other aspects will be provided later. So, your revenue is part-earned and part-deferred.

These can lead to accounting issues for your company: the separate stages of delivery, whether you're delivering goods or a service, must be tracked carefully.

Bad practice with accounts can be the difference between life and death for SaaS companies. Proofing against human error and building up your understanding of the SaaS financial model is paramount.

We can see a model of multiple element revenue recognition here, where revenue from the various deliverables are tracked separately.