# Reporting and Interpreting Sales Revenue, Receivables, and Cash

## CHAPTER 6

# Accounting for Sales Revenue

The revenue principle requires that revenues be recorded when earned:

**Goods or services have been delivered.**

**Amount of customer payments known.**

**Collection is reasonably assured.**

# Credit Sales

Selling on credit creates both benefits and costs:

Benefits - Customers  who are unwilling or unable to pay cash immediately may make a purchase on credit, and company revenues and profits rise as sales increase

Costs - The company will be unable to collect from some of its credit customers

01

# Credit Sales


**What is Men's Warehouse in business for?**

- **Selling great looking clothes**
- **Running a credit agency**
- **Concept of**
  - **"partnering"**
  - **"outsourcing"**

is provided by GE Money Bank, the issuer of the Perfect Fit Credit Card (the "Issuer").

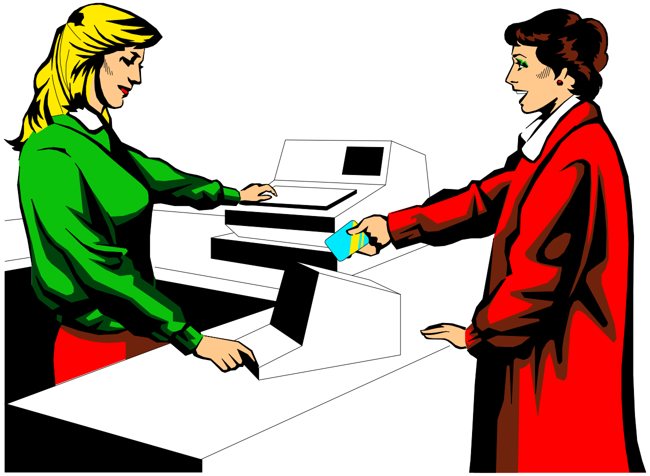
GE Money
UNITED STATES

# Credit Card Sales

Companies accept credit cards for several reasons:

1. To increase sales.
2. To avoid providing credit directly to customers.
3. To avoid losses due to bad checks.
4. To avoid losses due to fraudulent credit card sales.
5. To receive payment quicker.

When credit card sales are made, the company must pay the credit card company a fee for the service it provides.



# Sales Discounts

When customers purchase on open account, they may be offered a sales discount to encourage early payment.

***2/10, n/30***

**Discount Percentage**

**# of Days in Discount Period**

**Otherwise, the Full Amount Is Due**

**Maximum Days in Credit Period**

**Read as: "Two ten, net thirty"**

# To Take or Not Take the Discount

With discount terms of 2/10,n/30, a customer saves $2 on a $100 purchase by paying on the 10th day instead of the 30th day.

$$\text{Interest Rate for 20 Days} = \frac{\text{Amount Saved}}{\text{Amount Paid}}$$

$$\text{Interest Rate for 20 Days} = \frac{\$2}{\$98} = 2.04\%$$

$$\textbf{Annual Interest Rate} = \frac{\textbf{365 Days}}{\textbf{20 Days}} \times \textbf{2.04\%} = \textbf{37.23\%}$$

LIZ CLAIBORNE INC

What did we accomplish?

## CASH IS KING

In one of the most restrictive credit environments in history, we were able to secure an Asset Backed Loan (ABL) agreement. **We then drove a "cash is king" culture across the company, placing intense scrutiny on all that contributed to our fixed and variable expenses in order to maximize cash flow.** Throughout 2009, we worked closely with the bank group to secure less restrictive amendments to the ABL as our financial position improved quarter to quarter. Beyond instituting operating measures to generate cash, we tirelessly — and successfully — led lobbying efforts in Washington, DC to include an extension of the net operating loss carryback provisions in the American Recovery and Reinvestment Act of 2009 — a campaign that ultimately resulted in our receipt of a tax refund of approximately $167 million in March 2010, allowing us to further pay down our debt balance.

# Why do Firms Offer Discounts?

**Cash in your hands is most important!**

Incentivize customer to transfer cash to you
Speed your cash collections
Reduce your need for cash borrowings
Competitive advantage lost if no discount offered

# Sales Returns and Allowances

**Debited for damaged merchandise.**

**Debited for returned merchandise.**


**Contra revenue account.**

# Sales Returns and Allowances

A sales discount is a decrease in the cost of purchases earned by making an early payment to the vendor

A sales return is a decrease in the cost of purchases because the buyer returned the goods to the seller

A sales allowance is a decrease in the cost of purchases because the seller granted the buyer a subtraction (an allowance) from the amount owed

# Reporting Net Sales

Companies record credit card discounts, sales discounts, and sales returns and allowances separately to allow management to monitor these transactions.

Responsibility Accounting

**Sales revenue**

**Less: Credit card discounts**

**Sales discounts**

**Sales returns and allowances**

**Net sales**

# Reviewing Components of Net Sales

**Sales revenue** — Sales potential at MSRP, Original “sticker” price

**Less: Credit card discounts** — Cost of allowing credit card sales

**Sales discounts** — Cost of reducing sales prices to move items not selling (poor buying decisions, non-competitive price)

**Sales returns and allowances**

---

**Net sales** — Cost of customer service or poor quality of goods

# Gross Profit Percentage

Rev
-GOGS
-GP

$$\text{Gross Profit Percentage} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

In 2006, Deckers reported gross profit of $141,199,000 on sales of $304,423,000.

$$\textbf{Gross Profit Percentage} = \frac{\$141{,}399{,}000}{\$304{,}423{,}000} = 46.4\%$$

**2006 Gross Profit Comparisons**

| Deckers | Skechers U.S.A. | Timberland |
|---|---|---|
| 46.4% | 43.4% | 47.3% |

Book ... Not Prof!!

Other things equal, higher gross profit results in higher net income.

# Measuring and Reporting Receivables

When companies allow customers to purchase merchandise on an open account, the customer promises to pay the company in the future for the purchase.

Open Account

# Measuring and Reporting Receivables

When companies allow customers to purchase merchandise on an open account, the customer promises to pay the company in the future for the purchase.

**Accounts Receivable**

Trade receivables are amounts owed to the business for credit sales of goods, or services.

Nontrade receivables are amounts owed to the business for other than business transactions.

# Accounting for Bad Debts

Bad debts result from credit customers who will not pay the business the amount they owe, regardless of collection efforts.

**Matching Principle**

**Bad Debt Expense**

**Record in same accounting period.**

**Sales Revenue**

**Making a sale on credit is a decision to accept a RISK in period of sale for future non-payment**

# Accounting for Bad Debts

Bad debts result from credit customers who will not pay the business the amount they owe, regardless of collection efforts.

**Matching Principle**

**Bad Debt Expense**

**Record in same accounting period.**

**Sales Revenue**

Most businesses record an estimate of the bad debt expense with an adjusting entry at the end of the accounting period.

# Recording Bad Debt Expense Estimates

Deckers estimated bad debt expense for 2006 to be $4,685,000.

Prepare the adjusting entry.

**Bad Debt Expense is normally classified as a selling expense and is closed at year-end.**

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| Dec. | 31 | Bad Debt Expense (+E, -SE) | 4,685,000 | |
| | | Allowance for Doubtful Accounts (+XA) | | 4,685,000 |
| | | | | |

**Contra asset account**

# Allowance for Doubtful Accounts

Allowance for Doubtful Accounts is:

- ✓ the **estimated** amount of the receivables that the business expects **not to collect**
- ✓ a **contra account** related to Accounts Receivable
- ✓ another name for Allowance for Bad Debts

# Allowance for Doubtful Accounts

## Balance Sheet Disclosure

Accounts receivable

Less:  Allowance for doubtful accounts

---

**Net realizable value of accounts receivable**

Amount the business expects to collect.

# Writing Off Uncollectible Accounts

When it is clear that a specific customer's account receivable will be uncollectible, the amount should be removed from the Accounts Receivable account and charged to the Allowance for Doubtful Accounts.

Deckers' total write-offs for 2006 were $6,969,000.

Prepare a summary journal entry for these write-offs.

**GENERAL JOURNAL**

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| | | Allowance for Doubtful Accounts (-XA) | 6,969,000 | |
| | | Accounts Receivable (-A) | | 6,969,000 |
| | | | | |

# Writing Off Uncollectible Accounts

Assume that before the write-off, Deckers' Accounts Receivable balance was $62,640,000 and the Allowance for Doubtful Accounts balance was $13,069,000. Let's see what effect the total write-offs of $6,969,000 had on these accounts.

| | Before Write-Off | After Write-Off |
|---|---|---|
| Accounts receivable | $ 62,640,000 | $ 55,671,000 |
| Less: Allow. for doubtful accts. | 13,069,000 | 6,100,000 |
| Net realizable value | $ 49,571,000 | $ 49,571,000 |

The total write-offs of $6,969,000 did not change the net realizable value nor did it affect any income statement accounts.

# Estimating Bad Debt Expense Percentage of Credit Sales

**Bad debt percentage is based on actual uncollectible accounts from prior years' credit sales.**

**Alternatively, bad debt percentage can be based on industry standards**

**Focus is on determining the amount to record on the income statement as Bad Debt Expense.**

**INCOME STATEMENT APPROACH**

# Estimating Bad Debt Expense
## Percentage of Credit Sales

Net credit sales
× % Bad debt loss rate

Amount of journal entry to
Bad Debt Expense

Calculates

**INCOME STATEMENT APPROACH**

# Percentage of Credit Sales

In 2008, Kid's Clothes had credit sales of $600,000. Past experience indicates that bad debts are one percent of sales. What is the estimate of bad debts expense for 2008?

$\$600{,}000 \times .01 = \$6{,}000$

Now, prepare the adjusting entry.

**GENERAL JOURNAL**

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| Dec. | 31 | Bad Debt Expense (+E, -SE) | 6,000 | |
| | | Allowance for Doubtful Accounts (+XA) | | 6,000 |
| | | | | |

# Estimating Bad Debt Expense By Aging of Accounts Receivable

**Focus is on determining the desired balance in the Allowance for Doubtful Accounts on the balance sheet.**

Each customer's account is aged by breaking down (stratifying) the balance by showing the age (in number of days) of each part of the balance.

BALANCE SHEET APPROACH

# Aging Schedule

| Customer | Not Yet Due | Days Past Due 1-30 | 31-60 | 61-90 | Over 90 | Total A/R Balance |
|---|---|---|---|---|---|---|
| Aaron, R. | | $ 235 | | | | $ 235 |
| Baxter, T. | $1,200 | 300 | | | | 1,500 |
| Clark, J. | | | $ 50 | $ 200 | $ 500 | 750 |
| | | | | | | |
| Zak, R. | | | 325 | | | 325 |
| Total | $3,500 | $2,550 | $1,830 | $1,540 | $1,240 | $10,660 |
| % Uncollectible | 0.01 | 0.04 | 0.10 | 0.25 | 0.40 | |

Based on past experience, the business estimates the percentage of uncollectible accounts in each time category. These percentages are then multiplied by the appropriate column totals.

# Aging Schedule

| Customer | Not Yet Due | Days Past Due 1-30 | 31-60 | 61-90 | Over 90 | Total A/R Balance |
|---|---|---|---|---|---|---|
| Aaron, R. | | $ 235 | | | | $ 235 |
| Baxter, T. | $1,200 | 300 | | | | 1,500 |
| Clark, J. | | | $ 50 | $ 200 | $ 500 | 750 |
| | | | | | | |
| Zak, R. | | | 325 | | | 325 |
| Total | $3,500 | $2,550 | $1,830 | $1,540 | $1,240 | $10,660 |
| % Uncollectible | 0.01 | 0.04 | 0.10 | 0.25 | 0.40 | |
| Estimated Uncoll. Amount | $ 35 | $ 102 | $ 183 | $ 385 | $ 496 | $ 1,201 |

The column totals are then added to arrive at the total estimate of uncollectible accounts of $1,201.

Calculates

BALANCE SHEET APPROACH

# Aging of Accounts Receivable

Record the Dec. 31, 2008, adjusting entry assuming that the Allowance for Doubtful Accounts currently has a $50 credit balance.

**GENERAL JOURNAL**

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| Dec. | 31 | Bad Debt Expense (+E, -SE) | 1,151 | |
| | | Allowance for Doubtful Accounts (+XA) | | 1,151 |
| | | | | |

| | | |
|---|---|---|
| | 1,201 | Desired Balance |
| - | 50 | Credit Balance |
| | $ 1,151 | Adjusting Entry |

After posting, the Allowance account would look like this . . .

# Aging of Accounts Receivable

**Allowance for Doubtful Accounts**

| | | |
|---|---|---|
| | 50 | Balance at 12/31/2008 before adj. |
| | 1,151 | 2008 adjustment |
| | 1,201 | Balance at 12/31/2008 after adj. |

**Notice that the balance after adjustment is equal to the estimate of $1,201 based on the aging analysis performed earlier.**

# Aging of Accounts Receivable

| | |
|---|---|
| | Accounts Receivable |
| × | % Estimated Uncollectible |
| | Desired Balance in Allowance Account |
| - | Allowance Account **Credit** Balance |
| | Amount of Journal Entry |

| | |
|---|---|
| | Accounts Receivable |
| × | % Estimated Uncollectible |
| | Desired Balance in Allowance Account |
| + | Allowance Account **Debit** Balance |
| | Amount of Journal Entry |

# Review T-Accounts

# Receivables Turnover

$$\text{Receivables Turnover} = \frac{\text{Net Sales}}{\text{Average Net Trade Receivables}}$$

This ratio measures how many times average receivables are recorded and collected for the year.

# Receivables Turnover

Deckers reported 2006 net sales of $304,423,000.
December 31, 2005, receivables were $39,683,000 and
December 31, 2006, receivables were $49,571,000.

$$\text{Receivables Turnover} = \frac{\$304{,}423{,}000}{(\$39{,}683{,}000 + \$49{,}571{,}000) \div 2} = 6.8$$

**2006 Receivables Turnover Comparisons**

| Deckers | Skechers | Timberland |
|---|---|---|
| **6.8** | **7.7** | **8.4** |

# Receivables Turnover

| | |
|---|---|
| NORFOLK SOUTHERN | 10.4 |
| Walmart Save money. Live better. | 77.7 |
| BOEING | 14.4 |

# Focus on Cash Flows

Sales Revenue

Add Decrease in Accounts Receivable

Subtract Increase in Accounts Receivable

Cash Collected from Customers

# Cash and Cash Equivalents

Checks

Money Orders

Cash and Cash Equivalents

Certificates of Deposit

Bank Drafts

T-Bills

# Internal Controls

- **Internal control** is the organizational plan and all the related measures that an entity adopts to
  - Safeguard assets
  - Encourage adherence to company policies
  - Promote operational efficiency
  - Ensure accurate and reliable accounting records

# Internal Controls

American Airlines Ex-CEO Bob Crandall Shares His Crazy Cost-Saving Strategy

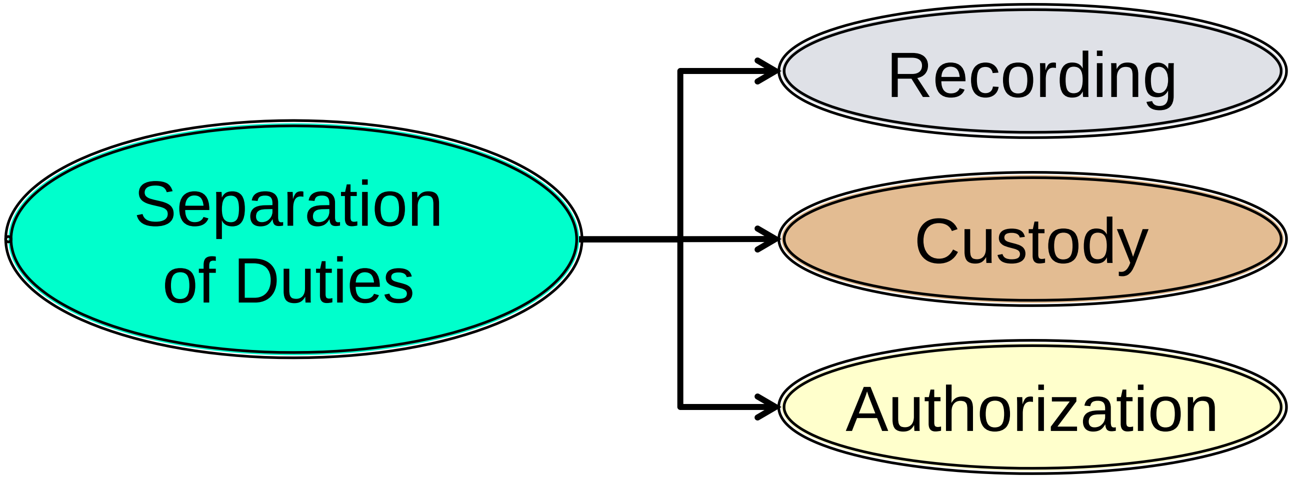
By consumeristcareyJanuary 12, 2008

Former American Airlines CEO Bob Crandall **fired a guard dog** at a Caribbean outpost to keep costs down. Just look at the self-satisfied gleam in Crandall's eye. This is no mere cocktail party story, but a defining act of corporate leadership for his grandkids to cherish

Oh, no. Not Fluffy!!!

# Internal Control of Cash

Cash is the asset most susceptible to theft and fraud.



The Office of Student Accounts is responsible for the timely dissemination of accurate information relating to a student's financial account at the University of Notre Dame.

**How much do I owe?**

**Where do I pay?**

**Where do I send payment for a Student Account?** Payments may be made by using the remittance envelope provided with the Student Accounts Statement or by mailing the payment to University of Notre Dame, P.O. Box 11116, South Bend, IN 46634-0116. Payments may also be made in person at the Notre Dame Federal Credit Union in the LaFortune Student Center on campus.

Accountability

Custody

# Internal Control of Cash

Bank Reconciliations

Daily Deposits

Purchase Approval

Cash Controls

Payment Approval

Check Signatures

Prenumbered Checks

# Chapter Supplement A — Recording Discounts and Returns

On January 2, a Deckers factory store's credit card sales were $3,000. The credit card company charges a 3% service fee.

**Credit Card Discounts are reported as a contra-revenue account.**

## GENERAL JOURNAL

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| Jan. | 2 | Accounts Receivable (+A)  | 2,910 | |
| | | Credit Card Discounts (+XR, -R, -SE) | 90 | |
| | | Sales Revenue (+R, +SE) | | 3,000 |
| | | $3,000 × 3% = $90 Credit Card Fee | | |

# Recording Sales Discounts

On January 6, Deckers sold $1,000 of merchandise on credit with terms of 2/10, n/30.

Prepare the Deckers journal entry.

**GENERAL JOURNAL**

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| Jan. | 6 | Accounts Receivable (+A) | 1,000 | |
| | | Sales Revenue (+R, +SE) | | 1,000 |
| | | | | |
| | | | | |

# Recording Sales Discounts

On January 14, Deckers receives the appropriate payment from the customer for the January 6 sale.

Prepare the Deckers journal entry.

$1,000 × 2% = $20 sales discount

$1,000 - $20 = $980 cash receipt

GENERAL JOURNAL

| Date | | Description | Debit | Credit |
| --- | --- | --- | --- | --- |
| Jan. | 14 | Cash (+A) | 980 | |
| | | Sales Discounts (+XR, -R, -SE) | 20 | |
| | | Accounts Receivable (-A) | | 1,000 |

Contra-revenue account

# Recording Sales Discounts

If the customer remits the appropriate amount on January 20 instead of January 14, what entry would Deckers make?

**Since the customer paid outside of the discount period, a sales discount is not granted.**

**GENERAL JOURNAL**

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| Jan. | 20 | Cash (+A) | 1,000 | |
| | | Accounts Receivable (-A) | | 1,000 |
| | | | | |
| | | | | |

# Recording Sales Returns

On July 8, ***before*** paying, a customer returns \$500 of sandals originally purchased on account from Deckers. The sandals originally cost Deckers \$300.

Prepare the Deckers journal entry.

**GENERAL JOURNAL**

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| July | 8 | Sales Returns (+XR, -R, -SE) | 500 | |
| | | Accounts Receivable (+A) | | 500 |
| | | | | |
| July | 8 | Merchandise Inventory (+A) | 300 | |
| | | Cost of Goods Sold (+E, -SE) | | 300 |
| | | | | |

# Recording Sales Returns

On July 8, ***after*** paying, a customer returns $500 of sandals originally purchased on account from Deckers. The sandals originally cost Deckers $300.

Prepare the Deckers journal entry.

**GENERAL JOURNAL**

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| July | 8 | Sales Returns (+XR, -R, -SE) | 500 | |
| | | Refunds Payable (+L) | | 500 |
| | | | | |
| July | 8 | Merchandise Inventory (+A) | 300 | |
| | | Cost of Goods Sold (+E, -SE) | | 300 |
| | | | | |

# Recording Sales Allowances

On July 8, ***before*** paying, a customer keeps $500 of sandals originally purchased on account from Deckers and agrees to pay only $200 as they are the wrong color.

Prepare the Deckers journal entry.

**GENERAL JOURNAL**

| Date | | Description | Debit | Credit |
|---|---|---|---|---|
| July | 8 | Sales Allowances (+XR, -R, -SE) | 300 | |
| | | Accounts Receivable (+A) | | 300 |
| | | | | |
| | | | | |
| | | | | |
| | | | | |


Unlock to Value
In Receivables !

# Hidden Value in Receivables: **Factoring**

- Sell receivables in whole (or blocks) to 3rd party
- Receive cash upon transfer
- With or without recourse (who bears cost of uncollectible account)
- Sample journal entry

**GENERAL JOURNAL**

| Date | | Debit | Credit |
|---|---|---|---|
| July 8 | Cash (+A) | 900 | |
| | Financing Expense (+XP, -SE) | 100 | |
| | Accounts Receivable (-A) | | 1,000 |