Chapter 6

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Accounting for Net Sales Revenue

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The **revenue recognition principle** requires revenues be recorded when the company transfers goods and services to customers.

For seller of goods, sales revenue is recorded when title and risks of ownership transfer to the buyer. The point in which title(ownership) changes hands is determined by the shipping terms in the sales contract

When goods are shipped **FOB (free on board) shipping point**, title changes hands at shipment and the buyer normally pays for shipping.

The appropriate amount of revenue to record is the amount it expects to be entitled to receive.

Motivating Sales and Collections

To motivate customers to buy its products and make payment for their purchases, companies

1. Allow customers to use credit cards to pay for purchases
2. Provides business customers direct credit and discounts for early payment
3. Allow returns from all customers from circumstances

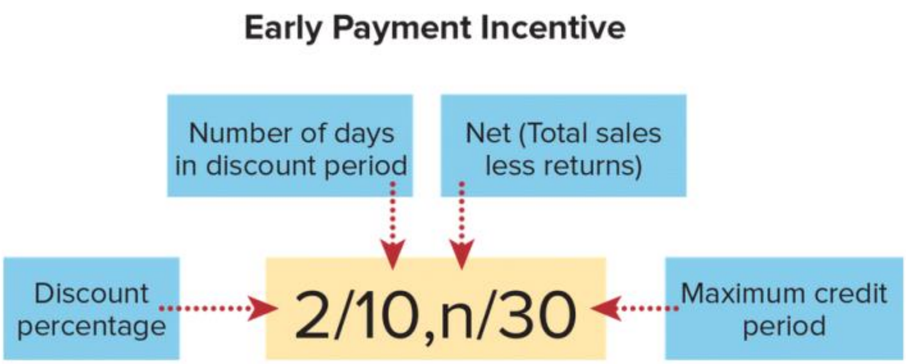
These methods will affect the way we compute net sales revenue

Credit card discount - the percentages or amount that credit card companies charge businesses for each transaction. (e.g. 3% discount means the business only receives 97% credit of each transaction's sale price)

Sales Discount to Business

Sales to business are usually credit sales on open account. (No formal written promissory note or credit card)

Credit terms are printed on the sales document and invoice(bill) sent to the customer.



Sometimes a **sales discount** is granted to encourage early payment. For example, in the image above we have a discount percentage of 2% if the payment is made within 10 days.
Two benefits of getting payments early:

1. Prompt receipt of cash reduces the necessity to borrow money to meet operating needs
2. Customers tend to pay bills providing discounts first, a sales discount decreases the chance that customer will run out of funds before this bill is paid.

If payment is made within the discount period,

Sales revenue	$1,000
Less: Sales discounts (0.02 × $1,000)	20
Net sales (reported on the income statement)	$ 980

We would record the sales revenue less the sales discounts.
If payment is not made within the discount period,
We would record the 1,000 as net sales.

Sales Return and Allowances

Retailers and customers have rights to return unsatisfactory or damaged merchandise and receive a refund or an adjustment to their bill. Such returns are often accumulated in a separate account called **Sales Returns and Allowances** and thus provides an important measure of quality of customer service.

Sales revenue	$2,000
Less: Sales returns and allowances (10 pairs × $50)	500
Net sales (reported on the income statement)	$1,500

Finally, Computing Net Sales

Credit card discounts, sales discounts, and sales returns and allowances are accounted for separately to allow managers to monitor the costs. Using the numbers in the preceding examples, the **amount of net sales** reported on the income statement is computed in the following:

Sales revenue	$6,000
Less: Credit card discounts (a contra-revenue)	90
Sales discounts (a contra-revenue)	20
Sales returns and allowances (a contra-revenue)	500
Net sales (included on the first line of the income statement)	$5,390

Measuring and Reporting Receivables

Classifying Receivables

Receivables may be classified in three different ways.

1. Either

    a. An account receivable
        i. Created by a credit sale on an open account
    b. A note receivable
        i. A promise in writing (a formal document) to pay
            1) A specified amount of money (the **principal**) at a future date (**maturity date**)
            2) A specified amount of **interest** at one or more future days (amount charged for use of the principle)
2. Either
    a. Trade receivable
        i. Created in the normal course of business when a sale of merchandise or services on credit occurs
    b. Nontrade receivable
        i. Arises from transactions other than the normal sale of merchandise or services.
3. In a classified balance sheet,
    a. Current
    b. Noncurrent

Accounting for Bad Debts

For billing and collection purposes, Skechers (a shoe company) keeps a separate accounts receivable account for each retailer (called **subsidiary account 附属账户**). The accounts receivable amount on the balance sheet represents the sum of all of these individual customer accounts.

But what if some its retailers won't pay their debts?
The expense recognition principle **requires** <u>recording of bad debt expense in the same accounting period</u> in which the related sales are made.
However, Skechers may not learn which particular customers will not pay until the next accounting period.
In order to solve this problem, we will present the **<u>allowance method</u>** to measure bad debt expense. It is based on **estimates** of the amount of bad debts. Two primary steps of the allowance method are:

1. Making the end-of-period adjusting entry to record estimated bad debt expense.
2. Writing off specific accounts determined to be uncollectible during the period.

Recording Bad Debt Expense Estimates

Dad Debt Expense is the expense associated with estimated uncollectible accounts receivable. An **<u>adjusting journal entry</u>** <u>at the end of the accounting period</u> records the bad debt estimate.

	Debit	Credit
Bad debt expense (+E, −SE)	18,398	
Allowance for doubtful accounts (+XA, −A)		18,398

Assets		=	Liabilities	+	Stockholders' Equity	
Allowance for doubtful accounts	−18,398				Bad debt expense (+E)	−18,398

The bad debt expense is included in the category "General and Administrative Expense" on the income statement.
Accounts Receivable could not be credited in the journal entry because there is no way to know which customer's account receivables are involved. So the credit is made instead to a contra-asset account called **Allowance for doubtful accounts**. As a contra-asset, the balance in Allowance for Doubtful Accounts is always subtracted from the balance of the asset Accounts Receivable.

Writing Off Specific Uncollectible Accounts

Throughout the year when it is determined that a customer will not pay its debts (e.g. due to bankruptcy), the write-off that individual bad debt is recorded through a journal entry.

	Debit	**Credit**
Allowance for doubtful accounts (−XA, +A)	8,865	
Accounts receivable (−A)		8,865

Assets		=	**Liabilities**	+	**Stockholders' Equity**
Allowance for doubtful accounts	+8,865				
Accounts receivable	−8,865				

Note that this journal entry <u>did not affect any income statement accounts</u>. It did not record a bad debt expense because the estimated expense was recorded with an adjusting entry in the period of sale. Also, the entry did not change the net book value of accounts receivable.

Bad Debt Recoveries

If uncollectible accounts actually written off differ from the estimated amount previously recorded, a higher or lower amount of bad debt expense is recorded in the next period to make up for the previous period's error in estimate. **When estimates are found to be incorrect, financial statement values for prior annual accounting periods are not corrected.**
When a company receives a payment on an account that already has been written off, the journal entry to write off the account is reversed to put the account is reversed to put the receivable back on the books and then the collection of cash is recorded.

	Debit	Credit
Accounts receivable (+A)	677	
Allowance for doubtful accounts (+XA, −A)		677
Cash (+A)	677	
Accounts receivable (−A)		677

Summary of Bad Debt Accounting Process

Step	Timing	Accounts Affected	Financial Statement Effects
1. Record estimated bad debts adjustment	End of period in which sales are made	Bad Debt Expense (E) ↑	Net Income ↓
		Allowance for Doubtful Accounts (XA) ↑	Assets (Accounts Receivable, Net) ↓
2. Identify and write off actual bad debts	Throughout period as bad debts become known	Accounts Receivable (A) ↓	Net Income No effect
		Allowance for Doubtful Accounts (XA) ↓	Assets (Accounts Receivable, Net) No effect

Accounts Receivable Dec. 31, 2017

Accounts Receivable (Gross) (A)	$457,101
Allowance for Doubtful Accounts (XA)	51,180
Accounts Receivable (Net) (A)	$405,921

Accounts Receivable (Gross) (A)			
Beginning balance	368,491	Collections on account	4,066,685
Sales on account	4,164,160	Write-offs	8,865
Ending balance	457,101		

Allowance for Doubtful Accounts (XA)			
		Beginning balance	41,647
Write-offs	8,865	Bad debt expense adjustment	18,398
		Ending balance	51,180

Reporting Accounts Receivable and Bad Debts

EXHIBIT 6.2 Accounts Receivable on the Partial Balance Sheet

SKECHERS U.S.A. REAL WORLD EXCERPT: Annual Report

SKECHERS U.S.A., INC. AND SUBSIDIARIES

Consolidated Balance Sheets (partial)

December 31, 2017 and 2016

(amounts in thousands)

	2017	**2016**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 736,431	$ 718,536
Trade accounts receivable, net of allowances of $51,180 in 2017 and $41,647 in 2016	405,921	326,844
Other receivables	27,083	19,191
Inventories	873,016	700,515
Prepaid expenses and other current assets	62,573	62,680
Total current assets	$2,105,024	$1,827,766

Source: Skechers U.S.A., Inc.

EXHIBIT 6.3 Accounts Receivable Valuation Schedule (Form 10-K)

SKECHERS U.S.A. REAL WORLD EXCERPT: Annual Report

Schedule II—Valuation and Qualifying Accounts

Years Ended December 31, 2017, 2016, 2015

(amounts in thousands)

	Balance at Beginning of Year	Additions	Deductions	Balance at End of Year
December 31, 2015	$21,007	$ 7,520	$ 4,267	$24,260
December 31, 2016	24,260	30,820	13,433	41,647
December 31, 2017	41,647	18,398	8,865	51,180

Source: Skechers U.S.A., Inc.

Estimating Bad Debts

Bad Debt Estimates often based on:

1. A percentage of total credit sales for the period
    a. Bases bad debt expense on the historical percentage of credit sales that result in bad debts
    b. Divide total bad debt sales by total credit sales
    c.

Credit sales	$1,500,000
× **Bad debt loss rate** (1.0%)	× 0.01
Bad debt expense	$ 15,000

2. An aging of accounts receivable
    a. Relies on the fact that as accounts receivable becomes older and more overdue, it is less likely that they will be collected.
    b. A receivable that was due in 30 days but has not been paid after 120 days is less likely to be collected, on average.
    c. Based on past experience, management would then estimate the probable bad debt loss rates for each category
        i. e.g. not yet due, 2%, 1 to 90 days past due, 12%, >90 days past due, 30%

d.

Aging Schedule 2018

Aged Accounts Receivable			Estimated Percentage Uncollectible		Estimated Amount Uncollectible
Not yet due	$230,000	×	2%	=	$ 4,600
Up to 90 days past due	138,000	×	12%	=	16,560
Over 90 days past due	92,000	×	30%	=	27,600
Estimated ending balance in Allowance for Doubtful Accounts					48,760
Less: Balance in Allowance for Doubtful Accounts before adjustment (51,180 – 17,420)					33,760
Bad Debt Expense for the year					$15,000

Allowance for Doubtful Accounts (XA)

2018 Write-offs	17,420	2018 Beginning balance	51,180	
		2018 Bad debt expense adjustment	?	=15,000
		2018 Ending balance	48,760	Total estimated uncollectible accounts

Comparison between two methods

The percentage of total sales from the period method is different from the aging of accounts receivable method that:

1. Percentage of total sales method:
   a. Directly compute the amount to be recorded as **Bad Debt Expense** on the Income Statement for the period in the adjusting journal entry.
2. Aging of Accounts Receivable method:
   a. Compute the **estimated ending balance** we would like to have in the **Allowance for Doubtful Accounts** on the Balance Sheet After we make the necessary adjusting entry.
   b. The **difference** between the current balance in the account and the estimated balance is recorded as the adjusting entry for Bad Debt Expense for the period

Receivables Turnover Ratio

$$\text{Receivables Turnover} = \frac{\text{Net Sales*}}{\text{Average Net Trade Accounts Receivable}^{\dagger}}$$

Reporting and Safeguarding Cash

Cash - money or any instrument that banks will accept for deposit and immediate credit to a company's account, such as check, money order, or bank draft.
Cash Equivalent - investments with original maturities of three months or less that are readily convertible to cash and whose value is unlikely to change

Cash Management

Effective cash management involves more than protecting cash from theft, but also taking responsibility to:

1. Accurate accounting so that reports of cash flows and balances may be prepared
2. Controls to ensure that enough cash is available to meet
   a. Current operating needs

    b. Maturing liabilities
    c. Unexpected emergencies
3. Prevention of the accumulation of excess amounts of idle cash
    a. Idle cash earns no revenue
    b. Rather invest in securities to earn a return until it is needed for operations.

Internal Control of Cash

<u>Internal Controls</u> - the process by which a company

1. safeguards its assets
2. provides reasonable assurance regarding
    a. the reliability of the company's financial reporting
    b. The effectiveness and efficiency of its operations
    c. Compliance with applicable laws and regulations
3. Extends to all assets

Because cash is the asset most vulnerable to theft and fraud, a significant number of internal control procedures should focus on cash.
Effective internal control of cash includes:

1. Separation of duties.
    a. Complete separation of the jobs of receiving cash and disbursing cash.
    b. Complete separation of the procedures of accounting for cash receipts and cash disbursements.
    c. Complete separation of the physical handling of cash and all phases of the accounting function.
2. Prescribed policies and procedures.
    a. Require that all cash receipts be deposited in a bank daily. Keep any cash on hand under strict control.
    b. Require separate approval of the purchases and the actual cash payments. Prenumbered checks should be used. Special care must be taken with payments by **electronic funds transfers** because they involve no controlled documents (checks).
    c. Assign the responsibilities for cash payment approval and check-signing or electronic funds transfer transmittal to different individuals.
    d. Require monthly reconciliation of bank accounts with the cash accounts on the company's books (discussed in detail in the next section).

Reconciliation of the Cash Accounts and Bank Statements

Content of a Bank Statement

Proper use of the bank accounts can be an important internal cash control procedure.
Each month, the bank provides the company (the depositor) with a bank statement**. Online banking provides this same information on a daily basis**.
The bank statement and the online banking site list

1. each paper or electronic deposit recorded by the bank during the period
2. each paper or electronic check cleared by the bank during the period
3. the bank charges or deductions (such as service charges) made directly to the company's account by the bank
4. the balance in the company's account.

EXHIBIT 6.4 Example of a Bank Statement

Texas Commerce Bank

7TH & LAVACA
AUSTIN, TEXAS 78789
PHONE: 512/476-6611

ROW.COM, Inc.
1000 Blank Road
Austin, Texas 78703

ACCOUNT NUMBER	STATEMENT DATE
877-95861	30-Jun-19

Activity in Date Order

Date	Description	Checks and Debits (14)	Deposits and Credits (5)	Balance
31-May	Balance Last Statement			7,762.40
02-Jun	Austin Energy - EFT	500.00		7,262.40
02-Jun	Deposit		3,000.00	10,262.40
03-Jun	Check 120	55.00		10,207.40
09-Jun	State Farm - EFT	100.00		10,107.40
09-Jun	Deposit		500.00	10,607.40
10-Jun	Check 122	8.20		10,599.20
11-Jun	Check 124	2,150.00		8,449.20
18-Jun	Check 125	46.80		8,402.40
18-Jun	INT		20.00	8,422.40
19-Jun	Check 127	208.00		8,214.40
24-Jun	Check 128	82.70		8,131.70
24-Jun	Deposit		230.00	8,361.70
25-Jun	NSF	18.00		8,343.70
25-Jun	Check 129	144.40		8,199.30
26-Jun	Check 132	22.52		8,176.78
26-Jun	Deposit		300.00	8,476.78
27-Jun	Check 130	96.50		8,380.28
30-Jun	Check 126	52.08		8,328.20
30-Jun	SC	6.00		8,322.20
30-Jun	This Statement	3,490.20	4,050.00	8,322.20

Code:
INT-Interest Earned
NSF-Not Sufficient Funds
SC- Service Charge
EFT-Electronic Funds Transfer

NSF Check ($18) => Company received check from customer, deposits the check in company's bank. But the customer doesn't have enough money in his/her account so the customer's bank returned the check to the company's bank, and now this NSF check is a receivable instead of cash equivalent. consequently, the company must make an entry to debit Receivables and credit Cash for the $18

bank reconciliation - process of comparing (reconciling) the ending cash balance in the company's records and the ending cash balance reported by the bank on the monthly bank statement.

1. Should be completed at the end of each month
2. Usually the ending balance as shown on the bank statement does not agree with the ending cash balance shown by the related Cash ledger account on the books on the company
    a. Most of the difference exists because of
        i. Outstanding Checks
            1) checks written by the company and recorded in the company’s ledger as credits to the Cash account that have not cleared the bank (they are not shown on the bank statement as a deduction from the bank balance).
            2) identified by comparing the list of canceled checks on the bank statement with the record of checks (such as check stubs or a journal) maintained by the company

ii. Deposit in transit
    1) deposits sent to the bank by the company and recorded in the company's ledger as debits to the Cash account
    2) The bank has not recorded these deposits (they are not shown on the bank statement as an increase in the bank balance). Deposits in transit usually happen when deposits are made one or two days before the close of the period covered by the bank statement.
    3) determined by comparing the deposits listed on the bank statement with the company deposit records

iii. Bank Service Charges
    1) expenses for bank services listed on the bank statement but not recorded on the company's books

iv. NSF Checks
    1) "bad checks" or "bounced checks" that have been deposited but must be deducted from the company's cash account and rerecorded as accounts receivable

v. Interest.
    1) interest paid by the bank to the company on its bank balance.

vi. Errors.
    1) Both the bank and the company may make errors, especially when the volume of cash transactions is large.

To prepare for bank reconciliation,

1. **Identify the outstanding checks.**
    a. A comparison of the checks and electronic payments listed on the bank statement with the company' s record of all checks drawn and electronic payments made showed the following checks were still outstanding (had not cleared the bank) at the end of June
    b.

Check No.	Amount
121	$ 145.00
123	815.00
131	117.20
Total	$1,077.20

2. **Identify the deposits in transit.**
    a. A comparison of the deposit slips on hand with those listed on the bank statement revealed that a deposit of $1,800 made on June 30 was not listed on the bank statement. This amount was entered on the reconciliation as an addition to the bank account. It will be added by the bank when it records the deposit.
3. **Record bank charges and credits:**
    a. Interest received from the bank, $20—entered on the bank reconciliation as an addition to the book balance; it already has been included in the bank balance.
    b. NSF check of R. Smith, $18—entered on the bank reconciliation as a deduction from the book balance; it has been deducted from the bank balance.
    c. Bank service charges, $6—entered on the bank reconciliation as a deduction from

the book balance; it has been deducted from the bank balance.

4. **Determine the impact of errors.**
   a. At this point, the company found that the reconciliation did not balance by $9. Upon checking the journal entries made during the month, the electronic payment on June 9 for $100 to pay an account payable was found. The payment was recorded in the company's accounts as $109. Therefore, $9 (i.e., $109 − $100) must be added to the book cash balance on the reconciliation; the bank cleared the electronic payment for the correct amount, $100.

A bank reconciliation accomplishes two major objectives:

1. Checks the accuracy of the bank balance and the company cash records
   a. Develops the correct (reported on the balance sheet) cash balance
2. Identifies any previously unrecorded transactions or changes that are necessary to cause the company's cash accounts to show the correct cash balance.
3.

	Debit	Credit
(a) Cash (+A)	20	
Interest income (+R, +SE)		20
To record interest by bank.		
(b) Accounts receivable (+A)	18	
Cash (−A)		18
To record NSF check.		
(c) Bank service expense (+E, −SE)	6	
Cash (−A)		6
To record service fees charged by bank.		
(d) Cash (+A)	9	
Accounts payable (+L)		9
To correct error made in recording a check payable to a creditor.		

HW Notes

3. Prepare a bank reconciliation for August.

Answer is complete and correct.

ALLISON COMPANY			
Bank Reconciliation, August 31, Current Year			
Company's Books		Bank Statement	
Ending balance per cash account	$ 24,155	Ending balance per bank statement	$ 21,715
Additions:		Additions:	
Interest collected	2,900	Deposits in transit	5,850
	27,055		27,565
Deductions:		Deductions:	
Bank service charges	130	Outstanding checks	640
Correct cash balance	$ 26,925	Correct cash balance	$ 26,925

Journal entry worksheet

1 2 3 4

Record the entry for deposits during August.

Note: Enter debits before credits.

Transaction	General Journal	Debit	Credit
A	No journal entry required		

Record entry | Clear entry | View general journal

Journal entry worksheet

1 2 3 4

Record the entry for checks cleared during August.

Note: Enter debits before credits.

Transaction	General Journal	Debit	Credit
B	No journal entry required		

Record entry | Clear entry | View general journal