FINANCIAL ACCOUNTING: FOUNDATIONS

OKTAY URCAN

Short-Term Assets

Overview

AGENDA

- Accounting for accounts receivables
- Accounting for inventories

INTRODUCTION

- Why short-term?
  - Accounts receivables and inventories are generally converted into cash within a year.

FINANCIAL ACCOUNTING: FOUNDATIONS

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Accounts Receivables: Cash Discounts

ACCOUNTS RECEIVABLES: VALUATION

- Accounts receivables
  - are not valued at face value on the balance sheet
  - but are valued at **net realizable value** (NRV)
  - **NRV** = Face value less cash discounts, sales returns, and bad debts

ACCOUNTS RECEIVABLES: CASH DISCOUNTS

- Discounts given over sale price if the customer pays in a certain time period to encourage early payment

ACCOUNTS RECEIVABLES: CASH DISCOUNTS - EXAMPLE

Illini Supermarket sells goods worth $2,000 to a customer on credit on January 1, 2016 (terms 3/15, n/30). Customer makes the payment on January 10, 2016.

	Assets		SHE
	Cash	AR	IS

ACCOUNTS RECEIVABLES: CASH DISCOUNTS - EXAMPLE

Illini Supermarket sells goods worth $2,000 to a customer on credit on January 1, 2016 (terms 3/15, n/30). Customer makes the payment on January 10, 2016.

	Assets		SHE
	Cash	AR	IS
Sale		2,000	2,000

ACCOUNTS RECEIVABLES: CASH DISCOUNTS - EXAMPLE

Illini Supermarket sells goods worth $2,000 to a customer on credit on January 1, 2016 (terms 3/15, n/30). Customer makes the payment on January 10, 2016.

	Assets		SHE
	Cash	AR	IS
Sale		2,000	2,000
Cash collection	1,940	(2,000)	(60)

2,000 – 60 = 1,940
It is net cash collection.

2000 * 3% = 60
It is a reduction from sales.

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Accounts Receivables: Sales Returns

ACCOUNTS RECEIVABLES: SALES RETURNS

- Some firms allow customers to return goods up to a certain time period.
- Firms need to estimate sales returns and record a provision for sales returns when the sales are made.
- This provision is called sales return allowance.
  - A contra asset
  - Netted against accounts receivable in the balance sheet

ACCOUNTS RECEIVABLES: SALES RETURNS - EXAMPLE

Illini Supermarket makes total sales of $50,000 in January 2016. Customers are allowed to return the goods within 30 days. Illini Supermarket expects 5% of goods to be returned based on past experience.

	Assets			SHE
	Cash	AR	Sales returns allowance	IS
Sale		50,000		50,000
Provision				

ACCOUNTS RECEIVABLES: SALES RETURNS - EXAMPLE

Illini Supermarket makes total sales of $50,000 in January 2016. Customers are allowed to return the goods within 30 days. Illini Supermarket expects 5% of goods to be returned based on past experience.

	Assets			SHE
	Cash	AR	Sales returns allowance	IS
Sale		50,000		50,000
Provision			(2,500)	(2,500)

Contra asset

It is a reduction from sales.

ACCOUNTS RECEIVABLES: SALES RETURNS - EXAMPLE

Illini Supermarket customers return goods worth $1,000 in the first week of February 2016.

	Assets			SHE
	Cash	AR	Sales returns allowance	IS
Sale		50,000		50,000
Provision			(2,500)	(2,500)
Sales returns		(1,000)	1,000	

FINANCIAL ACCOUNTING: FOUNDATIONS

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Short-Term Assets

Accounts Receivables: Bad Debts

ACCOUNTS RECEIVABLE: BAD DEBTS

- Bad debts occur when debtors do not pay.

- Bad debts
  - reduce the amount of accounts receivable on the balance sheet
  - create a loss in the income statement

ACCOUNTS RECEIVABLE: PROVISION FOR BAD DEBTS

- Just like sales returns, a provision for bad debts is created when sales are made.

- Bad debt provisions are calculated according to one of the following methods:
  - Percentage-of-sales method (most common)
  - Ageing schedule
  - Specific account analysis

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES METHOD

- Provision for bad debts is equal to a certain percentage of the credit sales.

- The percentage comes from either past experience or the bad debt rate of other firms in the same industry.

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

Illini Supermarket made total credit sales of $700,000 in year 2015. Illini Supermarket collected $500,000 by December 31, 2015. Expected bad debt rate is 5% of credit sales.

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Sales		700		700	

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Sales		700		700	
Collection	500	(500)			

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Sales		700		700	
Collection	500	(500)			
Provision			(35)	(35)	

700 * 5% = 35

1 This expense is called bad debt expense.
2. It is a part of administrative expenses.
3. It does not reduce sales.

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Sales		700		700	
Collection	500	(500)			
Provision			(35)	(35)	
Transfer to RE				(665)	665

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Sales		700		700	
Collection	500	(500)			
Provision			(35)	(35)	
Transfer to RE				(665)	665
Ending Balance	500	200	(35)		665

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

Illini Supermarket collects $100,000 from debtors in year 2016. In addition, debtors who owe $20,000 go into bankruptcy. Illini Supermarket is able to get $5,000 from these bankrupt debtors.

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Beginning balance	500	200	(35)		665

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Beginning balance	500	200	(35)		665
Collection	100	(100)			

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Beginning balance	500	200	(35)		665
Collection	100	(100)			
Collection	5	(20)	15		

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Beginning balance	500	200	(35)		665
Collection	100	(100)			
Collection	5	(20)	15		
Transfer to RE					

PROVISION FOR BAD DEBTS: PERCENTAGE-OF-SALES, EXAMPLE

	Assets			SHE	
	Cash	AR	Provision for doubtful accounts	IS	RE
Beginning balance	500	200	(35)		665
Collection	100	(100)			
Collection	5	(20)	15		
Transfer to RE					
Ending Balance	605	80	(20)		665

FINANCIAL ACCOUNTING: FOUNDATIONS

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Short-Term Assets

Accounts Receivables of Walmart

WALMART ASSETS 2015

Consolidated Balance sheets

(Amount in millions)	As of January 31 2015	2014
Assets		
Current assets:		
Cash and cash equivalents	**$ 9,135**	$ 7,281
Receivables, net	**6,778**	6,677
Inventories	**45,141**	44,858
Prepaid expenses and other	**2,224**	1,909
Current assets of discontinued operations	**---**	460
Total current assets	**63,278**	61,185
Property and equipment:		
Property and equipment	**177,395**	173,089
Less accumulated depreciation	**(63,115)**	(57,725)
Property and equipment, net	**114,280**	115,364
Property under capital leases:		
Property under capital leases	**5,239**	5,589
Less accumulated amortization	**(2864)**	(3,046)
Property under capital leases, net	**2,375**	2,543
Goodwill	**18,102**	19,510
Other assets and deferred charges	**5,671**	6,149
Total assets	**$203,706**	$204,751

WALMART: EXERCISE

1. Suppose that total provisions for sales returns is \$100 and doubtful accounts is \$400. What is the percentage of total accounts receivable Walmart does not expect to collect in year 2015?

Provisions / Total AR = 500 / (6,778 + 500) = 7%

\$7,278

WALMART: EXERCISE

2. Suppose that provision for doubtful accounts was $510 at the end of year 2014 and the amount of bad debt expense was $20 in year 2015. What is the amount of accounts receivable written off?

	Provision for doubtful accounts
Beginning balance	(510)
Bad debt expense	(20)
Write offs	?
Ending balance	(400)

WALMART: EXERCISE

2. Suppose that provision for doubtful accounts was $510 at the end of year 2014 and the amount of bad debt expense was $20 in year 2015. What is the amount of accounts receivable written off?

	Provision for doubtful accounts
Beginning balance	(510)
Bad debt expense	(20)
Write offs	130
Ending balance	(400)

FINANCIAL ACCOUNTING: FOUNDATIONS

OKTAY URCAN

Short-Term Assets

Inventories

INVENTORIES

Types:

- Manufacturing companies:
  - Raw materials
  - Work-in-progress
  - Finished goods

- Trading companies:
  - Goods available for sale

INVENTORY VALUATION

- Inventories are valued on the balance sheet as the lower of
  - cost or
  - net realizable value (NRV): sale price – selling costs

- Inventory values cannot be marked up over the cost.

INVENTORY WRITE-DOWNS

- Inventory write-down is needed when NRV is less than the cost.

- Inventory write-down
  - decreases the value of inventory account on the balance sheet
  - creates a corresponding expense on the income statement
  - is not reversible

FINANCIAL ACCOUNTING: FOUNDATIONS

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Short-Term Assets

Inventories: Cost Flow Assumptions

COST OF GOODS SOLD (COGS)

Retail Firm

	Cost of goods sold
	Beginning inventory
+	Purchases over the period
-	Ending inventory

Manufacturing Firm

	Cost of goods sold
	Beginning finished goods inventory
+	Transfer from WIP
-	Ending finished goods inventory

COST FLOW ASSUMPTIONS

- Firms cannot always keep track of goods purchased or sold.

- Cost flow assumptions are needed
  - Last-in-first-out method (LIFO)
  - First-in-first-out method (FIFO)
  - Average cost method

EXERCISE: COST FLOW ASSUMPTIONS

Calculate the cost of goods sold and ending inventory using LIFO, FIFO and weighted average methods

	Units	Unit cost	Unit price
Beginning inventory	100	$5	
January sale	(80)		$8
February purchase	30	$6	
March purchase	40	$7	
Ending inventory	90		

EXERCISE: COST FLOW ASSUMPTIONS

FIFO

- Cost of goods sold:

  80*$5 = $400 [It all comes from beginning inventory]

- Ending inventory:

  20*$5 [Remaining beginning inventory]

  \+ 30*$6 [February purchase]

  \+ 40*$7 [March purchase]

  = $560

EXERCISE: COST FLOW ASSUMPTIONS

LIFO

- Cost of goods sold:

  40*$7 [March purchase]

  + 30*$6 [February purchase]

  + 10*$5 [Beginning inventory]

  = $510

- Ending inventory:

  90*$5 = $450 [Remaining beginning inventory]

EXERCISE: COST FLOW ASSUMPTIONS

Weighted average

- Average unit cost:
  - Total purchase cost / Total number of units purchased = $5.65
  - Total purchase cost:

    100*$5 [Beginning inventory]

    + 30*$6 [February purchase]

    + 40*$7 [March purchase]
  - Total number of units purchased: 100 + 30 + 40

- Cost of goods sold = 80*$5.65 = $452
- Ending inventory = 90*$5.65 = $508

EFFECTS OF COST FLOW ASSUMPTIONS

Under increasing prices

	FIFO	LIFO
Ending inventory balance	Higher	Lower
Cash flows	Lower	Higher
Cost of goods sold	Lower	Higher
Income before taxes	Higher	Lower
Income taxes	Higher	Lower
Net income	Higher	Lower

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Inventories of Walmart

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WALMART INCOME STATEMENT 2015

Consolidated Statements of Income

(Amount in millions)	Fiscal Years Ended January 31		
	2015	2014	2013
Revenues:			
Net sales	**$482,229**	$473,076	$465,604
Membership and other income	**3,422**	3,218	3,047
Total revenues	**485,651**	476,294	468,651
Costs and expenses:			
Cost of sales	**365,086**	358,069	352,297
Operating, selling, general and administrative expenses	**93,418**	91,353	88,626
Operating income	**27,147**	26,872	27,725
Interest:			
Debt	**2,161**	2,072	1,977
Capital leases	**300**	263	272
Interest income	**(113)**	(119)	(186)
Interest, net	**2,348**	2,216	2,063
Income from continuing operations before income taxes	**24,799**	24,656	25,662
Provision for income taxes:			
Current	**8,504**	8,619	7,976
Deferred	**(519)**	(514)	(18)
Total provision for income	**7,985**	8,105	7,958
Income from continuing operations	**16,814**	16,551	17,704
Income from discontinued operations, net of income taxes	**285**	144	52
Consolidated net income	**17,099**	16,695	17,756
Less consolidated net income attributable to noncontrolling interest	**(736)**	(673)	(757)
Consolidated net income attributable to Walmart	**$ 16,363**	$ 16,022	$ 16,999

WALMART INVENTORY FOOTNOTES 2015

- Footnote 1: Summary of significant accounting policies
  - *Inventories: The Company values inventories at the lower of cost or market as determined primarily by the retail inventory method of accounting, using the last-in, first-out ("LIFO") method for substantially all of the Walmart U.S. segment's inventories.*

SUMMARY

In this module, you learned:

- Accounting for receivables
- Accounting for inventories

In the next module, you will learn accounting for long-term assets.