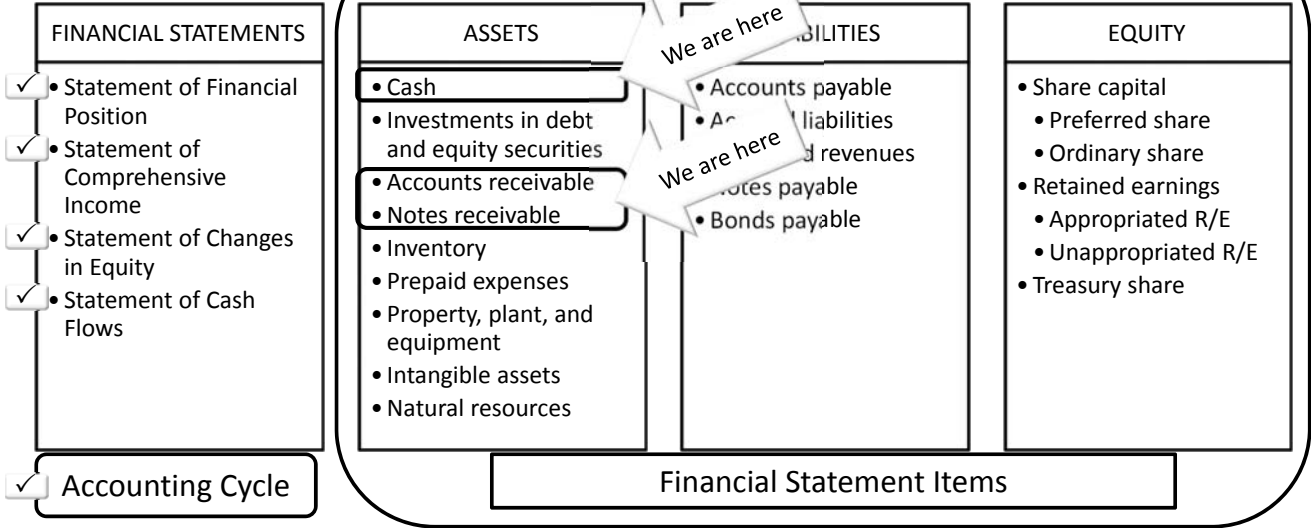
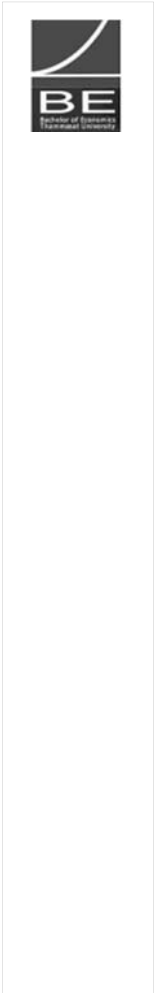


Introduction to Financial Statements



FINANCIAL STATEMENT ANALYSIS



AC201 Fundamental Accounting



BACHELOR of ECONOMICS

**CHAPTER 6:  
REPORTING AND INTERPRETING  
SALES REVENUE, RECEIVABLES,  
AND CASH**

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## Accounting for Sales Revenue

September 22, 2014

3



## Accounting for Sales Revenue

The revenue principle requires that **revenues** be recorded when **earned**.

1. Goods or services have been delivered.

2. There is persuasive evidence of a customer payment arrangement

3. Price is fixed or determinable.

4. Collection is reasonably assured.

September 22, 2014

4



## Reporting Net Sales

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

Sales revenue
<u>Less:</u> Credit card discounts
Sales discounts
Sales returns and allowances
<hr/>
<b>Net sales</b>

September 22, 2014

5



## I. Credit Card Sales to Consumers

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.



September 22, 2014

6



## Recording Credit Card Discounts

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

GENERAL JOURNAL				
Date		Description	Debit	Credit
Jan.	2	Cash (+A)	2,910	
		Credit Card Discounts (+XR, -R, -SE)	90	
		Sales Revenue (+R, +SE)		3,000
		To record credit card sales and credit card service fee of $\$3,000 \times 3\% = \$90$		

contra-revenue account



## II. Sales Discounts to Businesses

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

Net (Total sales less returns)

Maximum Days in Credit Period

Read as: **“Two ten, net thirty”**  
 The above credit term means the customer can deduct 2% from the invoice price if cash payment is made within 10 days from the date of sales.  
 If cash payment is not made with in 10 day discount period, the full sales price (less any returns) is due within a maximum of 30 days.



## To Take or Not Take the Discount, That is the Question

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

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

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

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

September 22, 2014

9



## Recording Sales Discounts

On January 6, adidas sold \$1,000 of merchandise on credit  
with terms of 2/10, n/30.  
Prepare the adidas journal entry.

GENERAL JOURNAL			
Date	Description	Debit	Credit
Jan. 6	Accounts Receivable (+A)	1,000	
	Sales Revenue (+R,+SE)		1,000
	To record sales of merchandise on credit		

September 22, 2014

10



## Recording Sales Discounts

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

Prepare the adidas journal entry.

$$\$1,000 \times 2\% = \$20 \text{ sales discount}$$

$$\$1,000 - \$20 = \$980 \text{ cash receipt}$$

GENERAL JOURNAL			
Date	Description	Debit	Credit
Jan. 14	Cash (+A)	980	
	Sales Discounts (+XR, -R, -SE)	20	
	Accounts Receivable (-A)		1,000
	To record payment from customer		

*September 22, 2014* 11

contra-revenue account



## Recording Sales Discounts

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

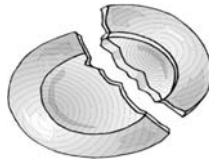
Since the customer paid outside of the discount period, a sales discount is not granted.

GENERAL JOURNAL			
Date	Description	Debit	Credit
Jan. 20	Cash (+A)	1,000	
	Accounts Receivable (-A)		1,000
	To record payment from customer		



### III. Sales Returns and Allowances

These situations are recorded in a separate account called **Sales Returns and Allowances**.



**Damaged merchandise.**



**Returned merchandise.**

September 22, 2014

13



### Recording Sales Returns and Allowances

On July 8, before paying, a customer returns \$500 of sandals originally purchased on account from adidas.  
Prepare the adidas journal entry.

GENERAL JOURNAL			
Date	Description	Debit	Credit
Jan. 8	Sales Returns and Allowances (+XR, -R, -SE)	500	
	Accounts Receivable (-A)		500
	To record return of merchandise		

contra-revenue account

September 22, 2014

14



## Reporting Net Sales

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

Sales revenue
<u>Less:</u> Credit card discounts
Sales discounts
Sales returns and allowances
<hr/>
<b>Net sales</b>

September 22, 2014

15



## Gross Profit Percentage

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

In 2009, adidas AG reported gross profit of \$4,712,000 on sales of \$10,381,000.

Gross profit percentage for adidas AG for 2009 is:

$$\frac{\$4,712,000}{\$10,381,000} = 45.4\%$$

COMPARISONS OVER TIME		
adidas		
2007	2008	2009
47.4%	48.7%	45.4%

COMPARISONS WITH COMPETITORS
Nike
2009
46.3%

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

September 22, 2014

16



## Measuring and Reporting Receivables

September 22, 2014

17



## Classifying Receivables

**Accounts receivable**  
are created when companies  
have sales to customers  
on open accounts.

**Notes receivable**  
are written promises  
from another party  
to pay with specified terms.

**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.

### Statement of Financial Position Classifications

- Current (short-term)
- Noncurrent (long-term)

September 22, 2014

18



## Accounting for Bad Debts

**Bad debts** result from credit customers who will not pay 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

adidas estimated bad debt expense for 2009 to be €68,000,000.  
Prepare the adjusting entry.

Bad debt expense (+E, -SE) .....	68		
Allowance for doubtful accounts (+XA, -A) .....			68
<b>Assets</b>	<b>=</b>	<b>Liabilities</b>	<b>+</b>
<b>Bad Debt Expense</b>			<b>Bad Debt Expense</b>
Allowance for doubtful accounts	-68		Bad debt expense (+E)
			-68

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



## Allowance for Doubtful Accounts

Statement of Financial Position Disclosure:

Accounts receivable
<u>Less: Allowance for doubtful accounts</u>
Net realizable value of accounts receivable



Amount the business  
expects to collect.



## Writing Off Specific 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.

adidas' total write-offs for 2009 were €34,000,000.  
Prepare a summary journal entry for these write-offs.

Allowance for doubtful accounts (−XA, +A) .....	63				
Accounts receivable (−A) .....					63
<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>	
Allowance for doubtful accounts	+63				
Accounts receivable	−63				



# Summary

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 } Assets (Accounts Receivable, Net) } No effect
		Allowance for Doubtful Accounts (XA) ↓	



# Estimation and Recording of Uncollectible Receivables



## Estimation of Uncollectible Receivables

An estimate of uncollectible accounts (bad debt expense) is required at the end of period. This estimate is normally based on past experience, industry averages, and forecasts of the future.

The company needs the following adjusting journal entry to record the estimated uncollectible accounts (bad debt expense) at the end of period:

Dr. Bad debt expense (+EXP, -SE)

Cr. Allowance for doubtful accounts (+XA, -A)

The two methods used to estimate uncollectible accounts are as follows:

1. Percentage of Sales Method
2. Aging of Accounts Receivable Method



## Estimating Bad Debts – Percentage of Sales Method

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

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



$$\begin{array}{r} \text{Net credit sales} \\ \times \text{ \% Bad debt loss rate} \\ \hline \text{Bad debt expense} \end{array}$$



## Estimating Bad Debts – Percentage of Sales Method

In 2010, 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 2010?

$$€600,000 \times 0.01 = €6,000$$

Prepare the adjusting entry.

GENERAL JOURNAL				
Date		Description	Debit	Credit
Dec.	31	Bad Debt Expense (+E,-SE)	6,000	
		Allowance for Doubtful Accounts (+XA,-A)		6,000
		To record bad debt expense.		

September 22, 2014

27



## Estimating Bad Debts – Aging of Accounts Receivable Method

**Focus is on determining the desired balance in the Allowance for Doubtful Accounts on the statement of financial position.**

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

An aging of accounts receivable for Kid's Clothes in 2010 might look like this . . .

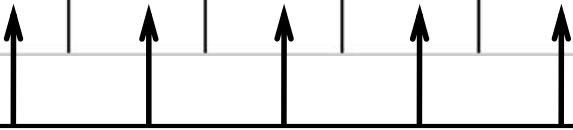
September 22, 2014

28



## Aging Schedule

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



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

Desired balance

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



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

Record the Dec. 31, 2010 adjusting entry assuming that the Allowance for Doubtful Accounts currently has a €50 credit balance.



## Estimating Bad Debts - Aging of Accounts Receivable Method

Desired balance

GENERAL JOURNAL			
Date	Description	Debit	Credit
Dec. 31	Bad Debt Expense (+E,-SE)	1,151	
	Allowance for Doubtful Accounts (+XA,-A)		1,151
	To record bad debt expense.		

1,201	Desired balance
- 50	Credit balance
<b>€ 1,151</b>	<b>Adjusting entry</b>

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

Allowance for Doubtful Accounts (XA)	
	50 Balance at 12/31/2010 before adjustment
	1,151 2010 adjustment
	<b>1,201</b> Balance at 12/31/2010 after adjustment

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



## Estimating Bad Debts - Aging of Accounts Receivable Method

➔

X	Accounts Receivable	
	% Estimated Uncollectible	
	<b>Desired</b> Balance in Allowance Account	
-	Allowance Account <b>Credit</b> Balance	
	Amount of Journal Entry	

➔

X	Accounts Receivable	
	% Estimated Uncollectible	
	<b>Desired</b> Balance in Allowance Account	
+	Allowance Account <b>Dedit</b> Balance	
	Amount of Journal Entry	



## Receivables Turnover Ratio

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

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

adidas reported 2009 net sales of €10,381,000. December 31, 2008, receivables were €1,624,000 and December 31, 2009, receivables were €1,429,000.

$$\text{Receivables Turnover} = \frac{€10,381,000}{(€1,624,000 + €1,429,000) \div 2} = 6.8 \text{ times}$$



## Average Collection Period

$$\text{Average Collection Period} = \frac{365}{\text{Receivables Turnover}}$$

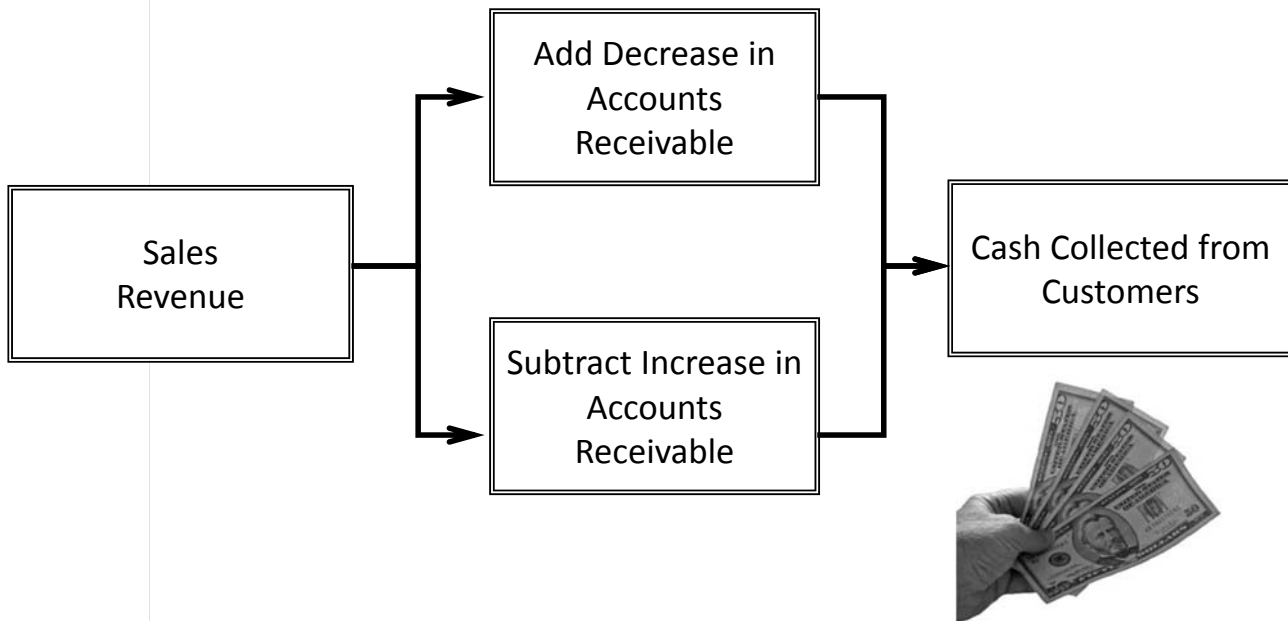
This ratio indicates the average time it takes a customer to pay its accounts.

adidas' Receivables Turnover was 6.8.

$$\text{Average Collection Period} = \frac{365}{6.8} = 53.7 \text{ days}$$



## Focus on Cash Flows



September 22, 2014

35



## Reporting and Safeguarding Cash

September 22, 2014

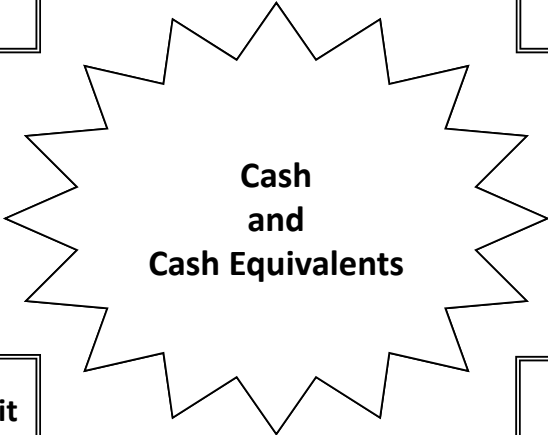
36



# Cash and Cash Equivalents

Checks

Bank Drafts



Certificates of Deposit

Money Orders

T-Bills



# Internal Control of Cash

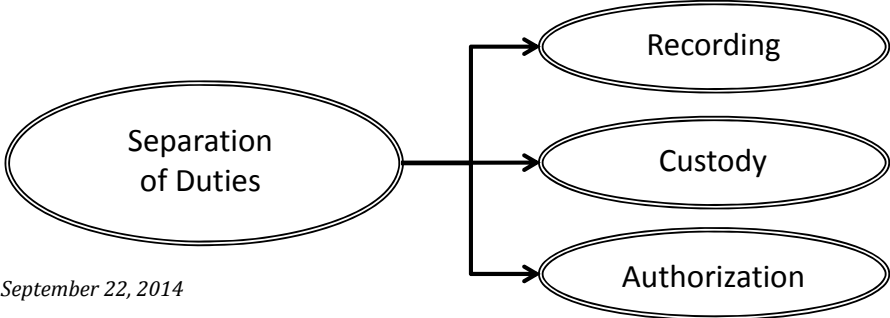
Internal control refers to policies and procedures designed to:

Properly account for assets.

Safeguard assets.

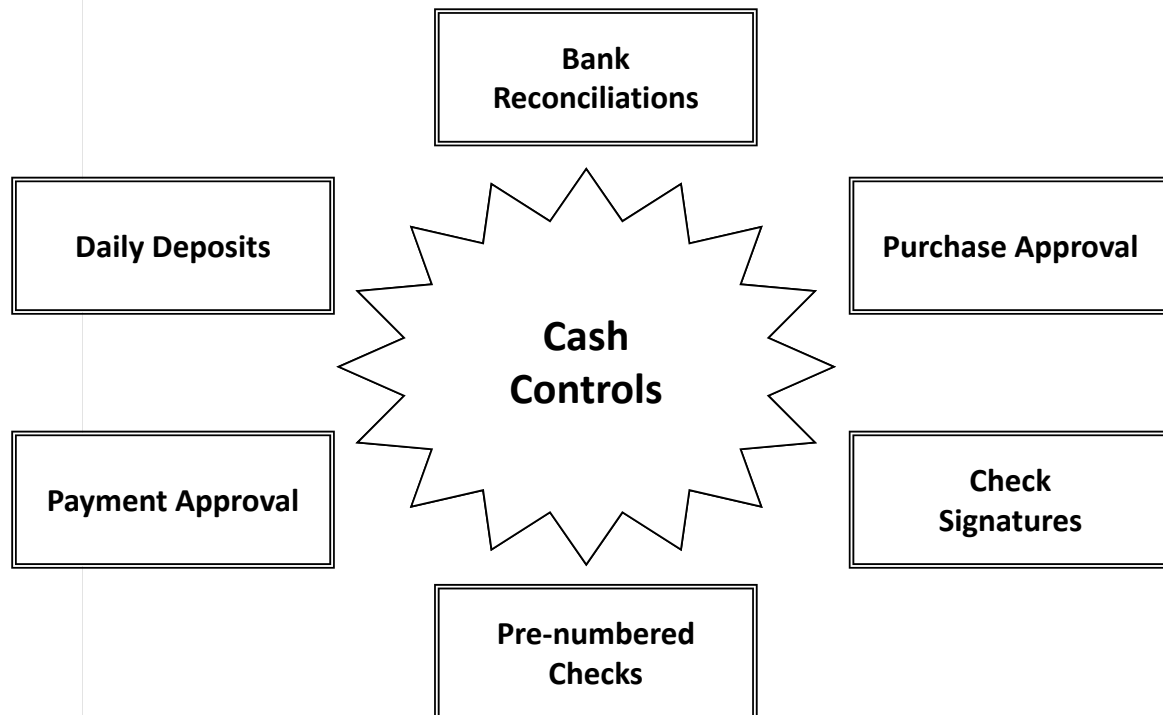
Ensure the accuracy of financial records.

**Cash** is the asset most susceptible to theft and fraud.





## Internal Control of Cash



September 22, 2014

39



## Bank Reconciliation (1)

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

- It is an important part of internal control.
  - Need for calculating a true cash balance
- Two "sections" to be reconciled
  - balance per bank
  - balance per books
- If there are any mistakes or transactions that have not been recorded in the company's books, adjusting journal entries will be needed.
  - Book errors: These are numerical errors made by either the company or the bank. The most common is transposition of numbers.

September 22, 2014

40



## Bank Reconciliation (2)

### Possible Difference between What You and Your Bank Know

#### Your bank may not know about . . .

1. Errors made by the bank
2. Time lags
  - a. Deposits that you made recently
  - b. Checks that you wrote recently

#### You may not know about . . .

3. Interest the bank has put into your account
4. Service charges taken out of your account
5. Customer checks you deposited but that bounced
6. Errors made by you

#### Adjustments to BANK balance

- **Deposit in transit:** The deposit that has not been processed by the bank as of the bank statement date, usually because it was made at or near the end of the month.
- **Outstanding check:** A check that has been written and deducted from a company's cash account but have not cleared by the bank as of the bank statement date.

September 22, 2014

41



## Bank Reconciliation (3)

#### Adjustments to BOOK balance

- **Bank credits:** These are additions made by the bank to a company's account before they are recorded by the company. The most common source is **interest paid by the bank** on the account balance.
- **Bank debits:** These are deductions made by the bank that have not yet been recorded by the company. The most common are monthly service charges, NSF checks, and bank transfers out of the account.
  - **NSF (Non-sufficient-fund) check:** A check that is not honored by a bank because of insufficient cash in the check writer's account.
  - **Bank Service Charge:** The bank automatically reduces the depositor's account balance for monthly fee for servicing an account.

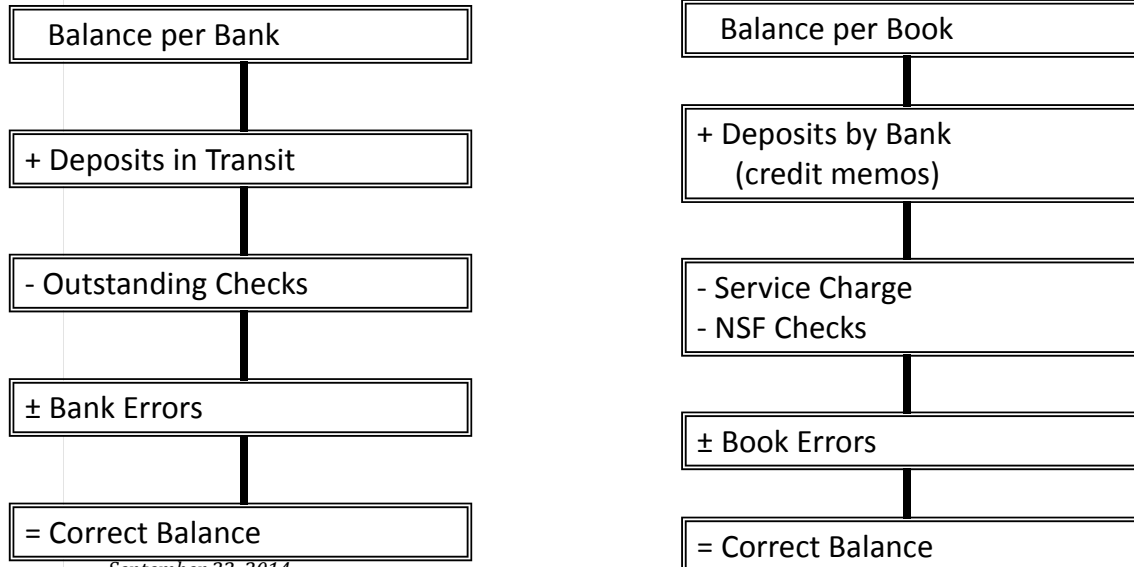
September 22, 2014

42



## Bank Reconciliation (4)

Explains the difference between **cash reported on bank statement** and **cash balance on company's books** and provides information for reconciling journal entries.



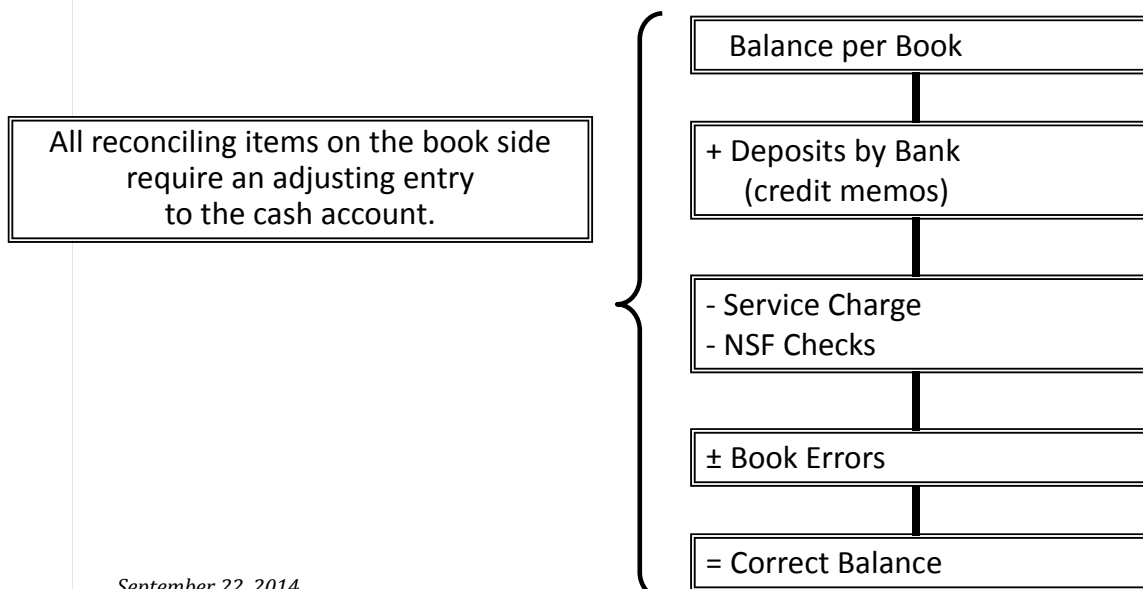
September 22, 2014

43



## Bank Reconciliation (5)

Explains the difference between cash reported on bank statement and cash balance on company's books and provides information for reconciling journal entries.



September 22, 2014

44



## Bank Reconciliation (6)

Prepare a July 31 bank reconciliation statement and the resulting journal entries for the Simmons Company. The July 31 bank statement indicated a cash balance of €9,610, while the cash ledger account on that date shows a balance of €7,430.

Additional information necessary for the reconciliation is as follows.

- Outstanding checks totaled €2,417.
- A €500 check mailed to the bank for deposit had not reached the bank at the statement date.
- The bank returned a customer's NSF check for €225 received as payment of an account receivable.
- The bank statement showed €30 interest earned on the bank balance for the month of July.
- Check 781 for supplies cleared the bank for €268 but was erroneously recorded in our books as €240.
- A €486 deposit by Acme Company was erroneously credited to our account by the bank.

September 22, 2014

45



## Bank Reconciliation (7)

Ending <b>BANK</b> balance, July 31		€	9,610
Additions:			
Deposit in transit			500
Deductions:			
Bank error	€	486	
Outstanding checks		2,417	2,903
			<u>2,903</u>
<b>Correct cash balance</b>		€	<u><u>7,207</u></u>
Ending <b>BOOK</b> balance, July 31		€	7,430
Additions:			
Interest			30
Deductions:			
Recording error	€	28	
NSF check		225	253
			<u>253</u>
<b>Correct cash balance</b>		€	<u><u>7,207</u></u>

46



## Bank Reconciliation (8)

Based on the bank reconciliation,  
these are the entries needed to **adjust the Cash account**.

GENERAL JOURNAL			
Date	Description	Debit	Credit
Jul 31	Cash (+A)	30	
	Interest Revenue (+R, +SE)		30
	To record interest earned on checking account		
31	Supplies Inventory (+A)	28	
	Accounts Receivable (+A)	225	
	Cash (-A)		253
	To correct bookkeeping error and adjust for NSF check		

September 22, 2014

47



## End of Chapter 6



September 22, 2014

48