

## **Chapter 6: Reporting and Interpreting Sales Revenue, Receivables, and Cash**

### CHAPTER SUMMARY

This Chapter discusses measuring, recording, and reporting revenues, cash, and receivables on the financial statements. Revenue recognition policies are widely recognized as one of the most important determinants of the final outcome of the financial statements. For most merchandisers and manufacturers, the appropriate revenue recognition point is the time of shipment or delivery of goods. For service companies, it is the time services are provided. Important issues facing companies are proper recording of credit card discounts and cash sales discounts, sales returns and allowances, and bad debt expense. Estimating, reporting, and evaluating bad debts are considered by companies where receivables are material. The accounts receivable turnover ratio is an important tool for companies. The gross profit percentage is also an important assessment tool for managers, analysts, and creditors.

Cash is the most liquid of all assets, and it flows continually into and out of a business. As a result, cash presents some of the most critical control issues facing managers. Also, the management of cash is of critical importance to decision makers. Companies must have cash available to meet current needs, yet they must also avoid excess amounts of idle cash, which produce no revenue.

### CHAPTER OBJECTIVES

- LO1 Apply the revenue principle to determine the accepted time to record sales revenue for typical retailers, wholesalers, manufacturers, and service companies.
- LO2 Analyze the impact of credit card sales, sales discounts, and sales returns on the amounts reported as net sales.
- LO3 Analyze and interpret the gross profit percentage.
- LO4 Estimate, report, and evaluate the effects of uncollectible accounts receivable (bad debts) on financial statements.
- LO5 Analyze and interpret the accounts receivable turnover ratio and the effects of accounts receivable on cash flows.
- LO6 Report, control, and safeguard cash.

## CHAPTER OUTLINE

### **I. UNDERSTANDING THE BUSINESS**

- A.** It is important to understand the impact of net sales on the income statement and how the net sales amount is derived.
- B.** Cash and accounts receivable are important items listed as current assets on the balance sheet. They are critical elements for the cash management of a business.
  - 1.** They are also key in terms of fraud prevention. Proper internal controls over these assets should help to avoid misappropriation of their use.
  - 2.** Financial statement users carefully monitor these elements in the financial statements.

### **II. LO1 APPLY THE REVENUE PRINCIPLE TO DETERMINE THE ACCEPTED TIME TO RECORD SALES REVENUE FOR TYPICAL RETAILERS, WHOLESALERS, MANUFACTURERS, AND SERVICE COMPANIES.**

- A.** Revenue Recognition Principle
  - 1.** Revenues are reported when they are earned.
  - 2.** An exchange has taken place, the earnings process is complete or nearly complete, and collection is probable.
  - 3.** Merchandising companies normally records sales revenue when goods are transferred to the buyer.
  - 4.** Service companies usually recognize revenue when services are performed.
  - 5.** Revenue recognition rules used by a company should be disclosed in the Notes, and should be applied consistently.
- B.** Shipping terms
  - 1.** FOB Destination – the title changes hands on delivery, and the seller normally pays for shipping.
  - 2.** FOB Shipping Point – the title changes hands at the shipping point, and the buyer normally pays for shipping.

### **III. LO2 ANALYZE THE IMPACT OF CREDIT CARD SALES, SALES DISCOUNTS, AND SALES RETURNS ON THE AMOUNTS REPORTED AS NET SALES.**

- A.** Cash Sales vs. Credit Card
  - 1.** Cash Sales
    - a.** “Cash” sales are sales for cash (currency) or customer checks.
    - b.** The entry to record cash sales includes a debit to Cash and a credit to Sales Revenue.
  - 2.** Credit Card Sales
    - a.** Many companies accept credit cards as “collections” for goods and services.
    - b.** Some widely accepted credit cards are American Express, Discover Card, MasterCard, and VISA.
    - c.** Reasons that companies accept credit cards for payment:
      - 1.** Increases customer traffic
      - 2.** Avoiding the costs of providing credit directly to consumers, including record keeping and bad debts.
      - 3.** Lowering losses due to bad checks.
      - 4.** Avoiding losses from fraudulent credit card sales (As long as the company follows the credit card company’s verification procedures, the credit card company absorbs any losses.)
      - 5.** Faster receipt of money. (Since credit card receipts are directly deposited.)
    - d.** Credit card companies charge a fee for their services.
      - 1.** The fee is called a credit card discount, and is usually a percentage of the credit card receipts.
      - 2.** The fee is an expense to the merchant. It may be reported as a contra revenue account (a reduction of gross revenues in arriving at net sales) or as a selling expense.

**B. Sales Discounts to Businesses**

1. Credit sales made on open account create a customer's promise to pay for goods or services at a later date. This is less formal than a promissory note. Credit sales are granted because of greater sales potential and competitors' practices.
2. When credit is extended, credit terms are printed on the invoice. The credit period indicates when the invoice amount (net of sales returns and allowances) is due.  
Example: "n/30" – net amount is due in 30 days.
3. Sales discount (cash discount) is an incentive to encourage early payment of open account charges. Early payment must be made within the discount period.  
Example: "2/10, n/30" – customer receives a 2% discount on the net amount due if payment is made within 10 days; otherwise n (net), the full amount, is due within 30 days. This provides two benefits:
  - a. It prompts the purchaser to pay early, which, in turn, increases the seller's cash available.
  - b. Since customers tend to pay bills providing discounts first, a sales discount also decreases the chances that the customer will run out of funds before paying their bill.

Sales discounts also benefit the purchaser. If the terms are 2/10, n/30, then the difference in the price is due to borrowing from the seller for 20 days (from the 10<sup>th</sup> to the 30<sup>th</sup>). To determine the annual interest rate, assume the original purchase was for \$100 of merchandise:

Amount saved / amount paid = interest rate for 20 days

$$\$2 / \$98 = 2.04\%$$

To annualize the interest rate:

Days in a year / days financed x 20 day interest rate = annual interest rate

$$[365 / 20] \times 2.04 = 37.23\%$$

Therefore, paying on time saves the company incurring interest expense.

**C. Sales Returns and Allowances**

1. A contra revenue account used to record the return of goods previously sold. It reduces gross sales to arrive at the net sales presented on the income statement.
2. Additionally, used to make adjustments to the sales price, as in the case of damaged goods.
3. It's important to maintain this account rather than to directly debit (reduce) the sales revenue account, because the SR&A account provides important information for management regarding the quality of sales and customer satisfaction.

**D. Reporting Net Sales**

|  |
|--|
| Sales  |
| - Sales Returns and Allowances               |
| - Sales Discounts (if a contra revenue)      |
| - Credit Card Discount (if a contra revenue) |
| <hr/>  |
| Net Sales                                    |
| <hr/> <hr/>                                  |

**IV. LO3 ANALYZE AND INTERPRET THE GROSS PROFIT PERCENTAGE.**

- A. Represents the markup percent. For every dollar of net sales, how much winds up as gross profit?
- B. The higher the gross profit ratio, the greater the markup.

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

**V. LO4 ESTIMATE, REPORT, AND EVALUATE THE EFFECTS OF UNCOLLECTIBLE ACCOUNTS RECEIVABLE (BAD DEBTS) ON FINANCIAL STATEMENTS.**

**A. Measuring and Reporting Receivables.**

- Receivables are claims against other companies or individuals for cash, goods, or services.
- Receivables can be classified three ways:
  - 1.** Accounts receivable vs. Notes receivable.
    - a. Account receivable (A/R)
      - i. Open accounts owed to a company by trade customers
      - ii. Created when sales are made on credit in the normal course of business.
      - iii. Normally a current asset because all are due within one year.
    - b. Note receivable
      - i. Written promises to pay evidenced by formal documents.
      - ii. The agreement contains the (1) sum of money due (principle), (2) the date the principal is due (maturity date), and (3) the interest rate and interest due dates.
  - 2.** Trade receivable vs. Non-trade receivable
    - a. Trade receivable is another name for accounts receivable.
    - b. Trade receivables arise from extending credit to customers in the normal course of business.
    - c. Trade discounts are different from Trade Receivables. A Trade Discount is a reduction “off the top” of the catalog or list price. The invoice price is net of the trade discounts. Sales revenue is recorded net of trade discounts.
    - d. Non-trade receivables arise from transactions other than in the normal course of business.
    - e. Non-trade receivables can be either current or non-current (short term or long-term), depending on when payment is expected.
    - f. Examples of Non-trade receivables include loans to officers and employees not evidenced by notes.
  - 3.** Current vs. Non-current – depends on when payment is expected; if payment is expected within a year, the receivable is considered current. If the payment is expected after a year, then the receivable is considered long-term or non-current.
  - 4.** Other issues:
    - a. Companies maintain separate records (subsidiary A/R ledger) for each customer. However, the total balance of the A/R account (control account) is presented on the balance sheet. The control account must always equal the sum of all the subsidiary A/R accounts.
    - b. Extending credit to customers is not without cost to the company. Billing systems and credit personnel must be maintained and not all customers will pay their debt to the company.

**B. Accounting for Bad Debts**

- 1.** Matching principle requires that bad debt expense is recorded in the same accounting period in which the sales are recorded.
- 2.** Bad debt expense is the estimated expense associated with uncollectible accounts.
- 3.** Allowance method bases bad debt expense on an estimate of uncollectible accounts, since it is unknown which specific accounts will be uncollectible; i.e., which customers will not pay their debts to the company.
- 4.** Two primary steps in the allowance method are:
  - a. Making the end-of-period adjusting entry to record bad debt expense.
  - b. Writing off specific accounts determined to be uncollectible during the period.

5. Bad debt expense is reported as an adjusting entry at the end of the accounting period:

|                                 |     |     |
|---------------------------------|-----|-----|
| Bad Debt Expense                | xxx |     |
| Allowance for Doubtful Accounts |     | xxx |

- a. Allowance for Doubtful Accounts is a contra (offset) asset account containing the estimated amount of uncollectible accounts receivable.
  - b. A/R cannot be credited for the estimated amount of uncollectible accounts since it is not known which specific accounts will not be paid.
  - c. Bad debt expense is a selling expense on the income statement. It decreases net income and stockholders' equity.
6. When it is determined that a specific account is uncollectible, that account should be written off against the allowance.

|  |     |     |
|--|-----|-----|
| Allowance for Doubtful Accounts        | xxx |     |
| Accounts Receivable (name of customer) |     | xxx |

- a. Note that no expense is recognized at this time because bad debt expense was recognized with the adjusting entry at the end of the previous period.
  - b. No income statement accounts are affected when a specific account is written off.
  - c. Net realizable value of accounts receivable (A/R minus Allowance for Doubtful Accounts) doesn't change because both of these accounts are reduced by the same amounts.
7. If a customer pays an account that was previously written off, the entry writing off the account must be reversed (the account must be reinstated), and then the collection of cash can be reported in the normal manner.
8. At the end of the accounting period, before the bad debt expense adjusting entry is made, the Allowance for Doubtful Accounts may have either a debit or a credit balance.
- a. A debit balance indicates that more specific accounts were written off than previously estimated.
  - b. A credit balance indicates that fewer specific accounts were written off than previously estimated.
9. After the end-of-period adjusting entry is made, the Allowance will always have a credit balance. Note that adjustments to prior periods are not made for incorrect estimates.

**C. Reporting Accounts Receivable and Bad Debts**

1. The Allowance for Doubtful Accounts is netted against A/R to report the "net realizable value" of accounts receivable for balance sheet reporting.
  - This represents the amounts that the company actually expects to collect.
2. Publicly traded companies include a detailed schedule of bad debt information in their Annual Report Form 10-K filed with the SEC if the amounts are material.

**D. Estimating Bad Debts**

There are two basic methods for estimating bad debt expense. Both are acceptable under GAAP.

1. Percentage of Credit Sales Method
  - a. Bases bad debt expense on the historical percentage of credit sales that results in bad debts.
  - b. Calculation:

$$\text{BadDebtExpense} = \text{Net Credit Sales} \times \text{Bad debt loss rate}$$

- c. The amount calculated is the amount of the adjusting journal entry, regardless of any balance in the allowance account prior to adjustment.
2. Aging of Accounts Receivable
    - a. Relies on the fact that, as accounts receivable become older and more overdue, it is more likely that they will be uncollectible.
    - b. Accounts receivable are divided into age categories, and a different loss rate is applied to each category. The oldest category would have the highest loss rate.

- c. The total of the estimated losses for all categories should be the balance in the allowance account after the adjusting entry has been made.
    - The unadjusted amount is compared to the estimated uncollectible amount to determine the amount of the adjustment needed. Therefore, once the total of the estimated amount of uncollectible accounts receivable is determined, the current balance in the allowance must be considered to determine the amount of the adjusting entry.
  - d. The aging of receivables method is more accurate than the percent of sales method.
- E. Control over Accounts Receivable**
1. Extending credit will increase sales volume, but credit sales are not an advantage to the company unless they can be collected.
  2. Practices to help minimize bad debt losses include:
    - a. Require approval of customers' credit history by a person independent of the sales and collection function.
    - b. Age accounts receivable periodically and contact customers with overdue payments.
    - c. Reward both sales and collections personnel for speedy collections so that they work as a team.

**VI. LO5 ANALYZE AND INTERPRET THE ACCOUNTS RECEIVABLE TURNOVER RATIO AND THE EFFECTS OF ACCOUNTS RECEIVABLE ON CASH FLOWS.**

- A. A measure of the effectiveness of a company's credit granting and collections activities. It reflects how many times average trade receivables are recorded and collected during the period.
- B. A higher ratio benefits the company.

$$\text{Receivables Turnover} = \frac{\text{Net credit sales}}{\text{Average net trade accounts receivable}}$$

**VII. LO6 REPORT, CONTROL, AND SAFEGUARD CASH.**

- A. Cash and Cash Equivalents Defined
  1. Cash: Money or any instrument that banks will accept for deposit or immediate credit to the depositor's account (check, money order, bank draft). Includes cash on hand and cash in banks.
  2. Cash equivalents: Short-term investments
    - a. Maturities of three months or less.
    - b. Readily convertible to cash.
    - c. Value is unlikely to change.
    - d. Examples: Certificates of deposit, U.S. government treasury bills.
- B. Cash Management
  1. Anyone can spend cash. It's impossible to determine the ownership of cash when presented for a purchase.
  2. Management has the responsibility to protect a company's cash. Responsibilities include:
    - a. Protect cash from theft and fraud.
    - b. Accurately account for cash flows and resulting balances.
    - c. Assure adequate amounts of cash are available for current operations, debt payment, and emergency needs.
    - d. Invest idle cash to earn a return.
- C. Internal Control of Cash
  1. Internal controls
    - a. Policies and procedures designed to safeguard all assets of the business (including cash) and to ensure the accuracy of financial reporting, the effectiveness and efficiency of its operations, and its compliance with applicable laws and regulations.
    - b. Controls over assets are designed to protect them from unauthorized use.
    - c. Controls over the accounting records are designed to prevent errors and fraud.

2. Effective internal control of cash includes:
  - a. Separation of duties.
    1. Responsibility for receiving cash should be given to someone other than the people responsible for disbursing cash.
    2. Accounting procedures for cash receipts and cash disbursements should be separate.
    3. There should be complete separating of the physical handling of cash and the accounting for cash.
  - b. Prescribed policies and procedures.
    1. All cash receipts should be deposited daily.
    2. Any cash on hand should be kept under strict control.
    3. Require separate approval for purchases and payments (pre-numbered checks should be used and special care should be taken with payments by electronic funds since there are no control documents).
    4. Require separate approval for payments and check signing.
    5. Reconcile the bank accounts at least monthly. (Should be done by someone without check signing authority, and someone not responsible for record keeping).

**D. Reconciliation of the Cash Accounts and the Bank Statements**

1. Bank statement: Periodic report (usually monthly) from a bank that shows recorded deposits, cleared checks, other reductions (bank services charges, NSF checks) and other increases (interest earned and note collection), and a running bank balance.
2. Bank reconciliation: The process of verifying the accuracy of both the bank statement and the cash account of the business. Timing differences and errors (by the bank and/or the company) may cause the ending bank balance to differ from the company's cash account balance.
  - a. The reconciliation is the process of comparing and updating the ending cash balance in the company's records and the ending cash balance reported by the bank on the monthly bank statement.
  - b. The adjusted balance per books and the adjusted balance per bank must equal after the reconciliation process.
  - c. All of the adjustments to the company's cash account related to the bank reconciliation require journal entries to update the cash account for proper balance sheet presentation.
  - d. Adjustments to the bank statement balances do not require journal entries because all of these items have already been recorded in the company's records.
    1. The bank should be notified of any errors on its part.
    2. Other reconciling items (timing differences) will be updated automatically as the bank posts deposits in transit and clears previously outstanding checks.

| Ending cash balance per books  | Ending cash balance per bank statement           |
|--|--|
| Add:<br>Notes collected by bank<br>Interest received or paid by bank                               | Add:<br>Deposits in transit                      |
| Deduct:<br>NSF checks<br>Bills and Interest paid by the bank<br>Bank charges<br>+/- Company errors | Deduct:<br>Outstanding checks<br>+/- Bank errors |
| Adjusted balance per books   | Adjusted balance per bank                        |

**VIII. Epilogue**

- Successful companies must control inventories, control production and purchase costs, and update their product lines to satisfy customer needs. By increasing sales and lowering cost of goods sold, gross profit will increase.