

## **Busi 293 Notes**

### **Chapter Seven**

### **Reporting and Interpreting Sales Revenue, Receivables and Cash**

In order to be successful, a company must sell its product/services for a profit and collect the cash from its sales. This chapter deals addresses how companies account for sales revenue – the revenue recognition principle.

Chapter 3 discussed that revenue should be recorded when the following conditions are have been satisfied:

- The selling entity has transferred to the buyer the significant risks and rewards of ownership of the goods? This is usually the transfer of legal title.
- The selling entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
- The amount of revenue can be measured reliably.
- It is probable that the economic benefits associated with the transaction will flow to the selling entity.
- The costs incurred or to be incurred in respect of the transaction can be measured reliably.

Determining whether revenue should be recognized is not always an easy decision and is, unfortunately, an area where management may attempt to inflate their company's results.

## Terms of Sale

In many situations revenue is recognized when title to the product is transferred from the seller to the buyer. There are two shipping terms you need to understand:

- **FOB shipping point** – title to the goods passes to the buyer when the goods are shipped (FOB means “free on board”)
- **FOB destination** – title to the goods passes to the buyer when the goods are delivered

The selling price of the product is often dependent on the quantity ordered by a customer. Those who buy more are often afforded lower prices. The ultimate sales price times quantity sold is referred to/recorded as gross sales. Such quantity discounts are not normally tracked in accounting systems

Some customers may be granted credit (i.e. the ability to pay their purchases after 30 or 60 days) while others may have to pay cash or settle their account with a credit card. When the textbook discusses credit sales or sales on account they are referring to situations where credit has been granted rather than sales settled with credit cards.

The journal entry to record a sale with cash is:

Dr Cash  
Cr           Sales revenue

The journal entry to record a sale on account is:

Dr Trade Receivables  
Cr           Sales revenue

## Sales paid with credit cards

The journal entry to record a sale paid with a credit card is:

Dr Cash  
Dr Credit card charge (\*)  
Cr           Sales revenue

(\*)Remember from the seller's point of view the bank charges a fee when a customer uses their credit card.

## Sales Discounts

All entities require a strong and healthy cash flow. If management cannot collect its trade receivables on a timely basis, the entity will be required to borrow funds to finance operations. To entice customers to pay quickly some companies offer a sales discount – a discount for early payment. You will often see the following notation on the bottom of a sales invoice:

**Terms 30 days** – this means the amount is due within 30 days of the invoice date

**Terms 2/10, n/30** – this means the seller will grant a 2% cash discount if the invoice is paid within 10 days. Should the discount not be taken, the full amount of the invoice is due within 30 days.

Terms vary among industries- some grant generous terms while others offer no cash discounts.

Please refer to textbook Reference A which illustrates why it is financially prudent to take sales discounts offered by the seller.

## **Sales Discounts** continued

Unlike quantity discounts, most companies who offer sales discounts track the discounts actually taken. When a customer takes a sales discount (i.e. a discount for early payment) the seller would record the following entry:

Dr Cash  
Dr Sales discount  
Cr        Trade receivables

The Sales discount account is a contra account - an account which offsets the sales account in the Statement of Earnings.

## **Sales Returns**

After purchasing a product, a customer may wish to return a product they have purchased or ask for a reduction in price because the product is either damaged or not exactly what was ordered. Each scenario will be discussed separately.

Should a customer wish to return a product it previously purchased, the seller would record the transaction as follows:

Dr Sale returns  
Cr        Trade receivables

Notice that the debit goes to Sales returns (another contra account) not the Sales account. Management usually sets up a Sales Returns account so they can monitor the level of returns – such information would be relevant to the seller.

## Sales Allowance

When a customer requests and is granted an allowance (i.e. a reduction in the initial sales price), the entry recorded by the seller is:

Dr Sales allowances  
Cr           Trade receivables

The Sales allowance account is another contra account.

While presentation may vary, various forms of presentation are presented in textbook Reference B. Management should be monitoring the level of any sales discounts, allowances and returns on an ongoing basis.

Assuming the company sells products as opposed to services, the next line on the Income Statement would be Cost of goods sold (sales). The difference between Net Sales and Cost of goods sold is gross profit or margin. You should understand that Gross Profit %'s vary between industries. This is the amount left over to cover operating costs.

## Measuring and Reporting Receivables

As noted above, Trade receivables (i.e. an asset) are created as a result of a credit sale. Trade Receivables are usually classified as current assets and should be separated from other non-trade receivables.

As one would expect, some customers are either unable or unwilling to pay their accounts - i.e. it will have some bad debts. How should a company account for trade receivables which prove to be uncollectible?

### Direct method

One approach is to wait until the account is known to be uncollectible and then simply write it off at that time. The journal entry would be:

Dr Bad debt expense  
Cr      Trade receivables

This approach, which is not widely accepted, is known as **the direct write-off method**. There are two drawbacks to this approach. First, it is dependent on determining when an account is deemed to be uncollectible (i.e. a management decision and therefore subject to manipulation) and secondly it results in a write-off being recognized in a different period than the original sale was recorded – a violation of the **matching** principle.

## Allowance Method

In order to satisfy the matching principle, most companies use the **Allowance Method**. Under this method, an estimate is made each period of the amount of bad debt expense. Estimates can be made using the **Percentage of Credit Sales Method** or the **Aging of Trade Receivables Method**. The first method focuses on the Statement of Earnings while the later method focuses on the Statement of Financial Position.

**Percentage of Credit Sales Method** (*Note this is not discussed in the course textbook*)

Under the Percentage of Credit Sales, the bad debt expense is determined by multiplying **Credit Sales** by an estimate of those sales which expected to be uncollectible - often based on prior credit history (usually expressed as a %).

The Journal entry is:

Dr Bad debt expense  
Cr Allowance for doubtful accounts

Allowance for doubtful accounts is a contra account offsetting Trade receivables.

When a specific trade receivable is actually known to be uncollectible, the journal entry under the allowance method is:

Dr Allowance for doubtful accounts  
Cr Trade receivables

Should an account previously written off become collectible the entry to reinstate the account is:

Dr Trade receivables  
Cr Allowance for doubtful accounts

**While the balance in Allowance for doubtful accounts may go into a debit balance during the year, it can never end the year in a debit balance.**

## **Aging of Trade Receivables Method**

The aging method estimates the ending balance in Allowance for doubtful accounts based on the amount of Trade Receivables thought to be uncollectible.

Please refer to textbook Reference C which provides you with the detailed calculations. Basically, the older a receivable, the greater the likelihood that the amount will be uncollectible. Under this method you first determine what the ending balance in the Allowance for doubtful accounts should be. Then compare this amount to the balance currently in the account (prior to your adjusting journal entry). The difference represents the amount of the journal entry.

Under this method, the journal entry for establishing the bad debt expense, the write-off of a receivable and the reinstatement of a receivable previously written off are the same as those determined under the percentage of credit sales method. However the actual amount of the bad debt expense would be different than that determined under the percentage of credit sales method)

There is a great deal of judgment required when establishing these estimates. Management should be monitoring write-offs carefully. Excessive write-offs may be indicative that credit is being granted to unsuitable customers i.e. (poor credit risks).

In practice, management's bias is to understate the Allowance for doubtful accounts therefore overstating Net Trade Receivables.

## **Financial presentation of Trade Receivables is:**

Trade Receivables  
Less: Allowance for doubtful accounts  
Net Trade receivables

## **FINANCIAL ANALYSIS**

In order to measure the effectiveness of management's credit-granting and collection policies you will find the **Receivables Turnover ratio** useful:

### **Calculation**

=Net Credit Sales/Average net Trade Receivables

As with all ratios, we are interested in trends within the company and with competitors in the industry.

In normal cases the higher the ratio the more effective the policies have been. It indicates Trade Receivables are being collected more quickly.

Another ratio, the **Average collection period**, determines the number of days' sales which sitting in Trade Receivables:

## Calculation

= Average Trade Receivables/Daily credit sales (Credit sales/365)

Or

365/ Receivables turnover ratio

With this ratio, a lower number reflects that management is doing a better job collecting receivables.

Note that two ratios are looking at management of receivables from different points of view.

## Gross Profit Percentage

Helps management determine whether the company is selling its products for more than the cost to purchase or produce the goods – i.e. is there enough to cover the operating costs of the business?

## Calculation

= Gross profit (Net sales – Cost of sales)/ Net Sales

A reduction in gross profit may indicate a more competitive environment or an increase in the costs of the product sold.

Management should pay particular attention to changes in gross profit percentages.

## Internal Control

As previously discussed, Management is responsible for the content of the financial statements. The larger the company, the more important it is to have effective internal controls. Internal controls are the policies and procedures used to ensure company's assets are protected, fraud and error are minimized and reliable financial information is produced. Please refer to textbook Reference D for a discussion of controls over Trade Receivables.

There are several high profile fraud cases in the US have forced the government to take action on improving internal controls. The Sarbanes-Oxley Act requires public companies to better protect the public. Public companies now require an audit of internal control over financial reporting.

## CASH

The accounting for cash is relatively straightforward. Cash balances are generally current assets unless some type of restriction has been placed on the funds. Due to its nature, cash is often the target of fraud. No person should have complete authority to receive, disburse and account for cash. Providing employees with tempting opportunities to steal case usually results in uninsured thefts. Please refer to textbook Reference E which discusses the importance of segregation of duties.

Other than ensuring proper supervision and approval of the cash function the most important internal control over cash is the preparation of monthly bank reconciliations. The purpose is to reconcile the balance in the accounting records of the company to the accounting records of the bank. Most differences arise from timing differences and errors. Timing differences arise because there is a lag between the date amounts are recorded in the accounting records and the date they are processed by the bank.

For example a cheque is prepared and recorded on December 29, 2014 and mailed to a supplier. The cheque may take 7-10 days to make its way to the bank – as a result, it will not be processed by the bank until 2015. Such differences are reasonable and require no adjustments. Timing differences may have to be investigated if they have been outstanding for a significant period of time.

Errors can result from company and/or bank mistakes such as incorrect recording of cheques and deposits, cashing or depositing cheques that do not belong to the company. Items recorded by the bank but not yet recorded by the company need to be addressed. Company errors and items not yet recorded must be corrected in the company's accounting records. Accounting records of the bank must be amended for identified bank errors. Please refer to textbook Reference F to view an example of a bank reconciliation.

Everyone should be reviewing their personal bank statements on a monthly basis to identify errors or differences. We do not examine bank reconciliations in this course.

## Revenue Recognition – (Please refer to textbook Reference G)

Thus far we have discussed revenue recognition as it relates to the sale of goods. How should we account for transactions that span a significant time frame? - i.e. over a number of years. Consider the construction of a bridge which is expected to cost \$40 million and take 4 years to complete. The construction company signs a contract for \$50 million and expects to earn a \$10 million profit. Many things can happen over a 4-year period so the exact profit will not be determined until the project is complete. Let's consider methods for accounting for such long-term contracts.

### Accounting for Long-term contracts

**Percentage of Completion method** allows companies to record revenue based on a **reliable measure** of the percentage of work completed during the accounting period. For example, if 25% of the project was completed in Year 1, 25% of the revenue and expenses would be recognized on the Statement of Earnings. Many feel this method better reflects the underlying transaction - i.e. a portion of the revenue and expenses are being earned/incurred in each period of the contract. Such information is both timely and relevant to users. This method may only be used when the percentage of completion can be reliably measured.

Please refer to my additional handout for a more detailed example. You will address this topic in greater depth in intermediate accounting classes.

If a reliable measure cannot be made, companies reporting under IFRS must use the **zero profit method**. Under this method companies will report revenue equal to the amount of costs incurred in the year.

Companies reporting under ASPE who do not choose to use percentage of completion method can use the **Completed Contract method**. This method, as the name suggests, only recognizes revenue and costs once the total project is completed. While the profit on the project is accurate, the information is not timely.

It should be noted that the percentage of completion method is also applicable to long-term service contracts.

When reviewing Annual Reports I encourage you to review the Revenue Recognition policies which are included in the Significant Accounting Policies of the financial statement notes.

Given the uncertainties and judgment involved in revenue recognition, it is not surprising that there are numerous examples of management manipulation. The overstatement of revenue is, unfortunately, an all-to-common occurrence. Further examples of revenue overstatements are bound to be reported over the course of our class. Be on the lookout for such news!