

CHAPTER 8

REVENUE CYCLE: SALES, RECEIVABLES, AND CASH

WHEN REVENUE IS RECOGNIZED

- Revenue should be recognized when two criteria are met:
 - The promised work has been substantially completed
 - Cash, or a valid promise of future payment, has been received



HOW REVENUE IS RECOGNIZED

- Revenue is recognized by an increase to Cash or Accounts Receivable and an increase to a revenue account



SELLING ON CREDIT AND COLLECTING CASH

- The primary costs associated with selling on credit are
 - Bad debts
 - Bookkeeping costs
 - Billing system
 - Processing collections
 - Carrying costs
 - The opportunity cost of not making a return on the cash tied up in the form of accounts receivable

CREDIT POLICIES

- The credit period determines when the cash will be collected
 - n/30, read “net thirty,” means that payment is due within 30 days from the date of the invoice
- Sales discounts are cash reductions offered to credit customers who pay their bills early

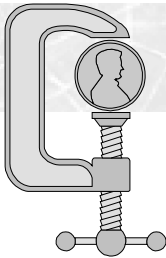
ACCOUNTING FOR CREDIT CUSTOMERS WHO DON'T PAY

- Bad debt expense is a natural consequence of selling merchandise on credit
- The matching concept requires that new bad debts be estimated and reported in the same year that the sales occur
- This estimation method is known as the allowance method

ACCOUNTING FOR CREDIT CUSTOMERS WHO DON'T PAY

- The allowance method uses one of two estimation procedures:
 - Percentage of sales method
 - Aging method
- Under either method an increase to **Bad Debts Expense** is recorded, along with a corresponding increase to **Allowance for Bad Debts** (a contra account to **Accounts Receivable**)

PERCENTAGE OF SALES METHOD



- Under this method, an estimate of bad debts expense is made by multiplying a percentage (based on past experience) times credit sales

PERCENTAGE OF SALES METHOD

- If Sales are \$200,000 and historically 3% of credit sales have become uncollectible, the following year-end entry would be made:

Bad Debts Expense	6,000
Allowance for Bad Debts	6,000

THE AGING METHOD

- The aging method involves dividing the Accounts Receivable balance into different age categories to estimate the amount of those accounts which will ultimately become uncollectible
- This balance sheet approach seeks to estimate an appropriate year-end balance for the Allowance for Bad Debts account

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THE AGING METHOD

- The chances that an account will ultimately be uncollectible increase as the account gets older
- Assume the following aging analysis for Accounts Receivable:

<u>Age of Account</u>	<u>Aged Balance</u>
Less than 30 days	\$27,600
31 to 60 days	5,800
61 to 90 days	3,100
Over 90 days	<u>3,500</u>
Total	\$40,000

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THE AGING METHOD

- Assigning percentages to each age category yields the following results:

<u>Age of Account</u>	<u>%</u>		<u>Required Allowance Amount</u>
	<u>Ultimately Uncollectible</u>	<u>Aged Balance</u>	
Less than 30 days	4%	\$27,600	\$1,104
31 to 60 days	20%	5,800	1,160
61 to 90 days	40%	3,100	1,240
Over 90 days	80%	<u>3,500</u>	<u>2,800</u>
Total		\$40,000	\$6,304

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THE AGING METHOD

- The year-end entry would be for an amount that would result in an Allowance for Bad Debts balance of \$6,304



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WRITE-OFFS OF BAD DEBTS

- When a specific account is determined to be uncollectible, both the Accounts Receivable and the allowance account are reduced
- The journal entry for writing off an uncollectible account with a \$3,200 balance would be

Allowance for Bad Debts 3,200
 Accounts Receivable 3,200

THE ALLOWANCE FOR BAD DEBTS T-ACCOUNT

- The following T-account depicts the events that affect the allowance account

Allowance for Bad Debts

	Beginning Balance
Subtract: Write-Offs	Add: Estimated Bad Debts
	Ending Balance

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ACCOUNTING FOR WARRANTIES

- Like bad debts expense, warranty expense must be estimated and recognized in the same period in which the revenue is recognized
- The accountant must estimate the expense before all of the facts are in



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ACCOUNTING FOR WARRANTIES

The year-end entry to record Veda Landscape's estimated Shrub Warranty Expense from planting 50 shrubs is

Shrub Warranty Expense	175	
Estimated Liability for Service		175

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ACCOUNTING FOR WARRANTIES

The entry to record actual warranty costs of replacing shrubs is

Estimated Liability for Service	145	
Cash (for employee labor)		100
Supplies (for replacment shrubs)		45

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THE ESTIMATED LIABILITY FOR SERVICE T-ACCOUNT

The following T-account depicts the events that affect the estimated liability account:

Estimated Liability for Service

Actual Cost Incurred	145	Estimate At Time of Sale	175
		Remaining Balance	30

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CASH MANAGEMENT

• Two methods of obtaining cash from receivables without waiting for collection from customers:

- Assignment of receivables
 - Specific receivables are used as collateral for a loan
 - Disclosure in the financial statement notes is required
- Factoring

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CASH MANAGEMENT

- Factoring involves one company selling some of its receivables to another company (the factor) who charges a fee for the service
- Receivables are usually sold “without recourse”
 - The factor assumes all the risk of collecting the receivables

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MANAGING THE QUANTITY OF ACCOUNTS RECEIVABLE

- The accounts receivable turnover determines how many times during the year a company is collecting its average receivable balance

$$\text{Accounts Receivable Turnover} = \frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

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MANAGING THE QUANTITY OF ACCOUNTS RECEIVABLE

- The accounts receivable turnover can be converted into the average collection period
- The lower the average collection period, the more favorable the ratio

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

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