


**Chapter 7, Module 1**

**Slide 1**

*Chapter 7 Module 1*

AMIS 211  
Introduction to Financial Accounting

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 **FISHER**  
COLLEGE OF BUSINESS

Hi everyone.

In this chapter we are going to talk about an issue that is very important and has a very important impact on a company's financial statements.

Now, please go to the next slide and let's go ahead to the next slide.

Slide 2

*Chapter 7 Module 1: Sales of our Product*

**Sales of our Product**

**Question: Which financial statement accounts are affected?**

<u>Income Statement</u>	<u>Balance Sheet</u>
1. Sales Revenue	1. Accounts Receivable
2. Cost of Goods Sold	2. Inventory

And, the issue that we are going to deal with is sales of our product—sales of our inventory to our customers.

And, the first question that we have to answer is this:

What financial statement accounts are affected when we have sales of our product?

The accounts that are affected on the financial statements:

On the Income Statement: we have to record the Sales Revenue—the revenue earned from selling the product; and the Cost of Goods Sold (CGS)—the cost of the inventory sold to customers.

On the Balance Sheet: we have to record the Accounts Receivable that we get from selling the goods; and we have to reduce the inventory to reflect the fact we no longer own it.

In this chapter—in this particular chapter—we will focus on those two right there. We will focus on the Sales Revenue and the Accounts Receivable.

In a later chapter, we will look at the other two components: the Cost of Goods Sold and the Inventory.

But for this one, we will focus on the Revenue side: Sales Revenue and Accounts Receivable.

And, let's go ahead to the next slide.

**Slide 3**

**Chapter 7 Module 1: Sales Revenue**

**Revenues are reported when earned in accordance with the realization principle (revenue recognition principle). The receipt of cash is not the determining factor.**

**Revenues are earned when the goods are sold or services are performed.**

**If cash is received prior to the sale of goods or performance of services it is considered unearned revenue.**

**If the sale of goods or performance of services occurs prior to the receipt of cash, it is an accrued revenue and an account receivable is recorded.**

And, let's start with the Sales Revenue component—something that should be a review for us.

Revenues are recorded in the period they are earned in accordance with the Realization Principle or the Revenue Recognition concept.

Remember: Revenue is recorded when earned. The determining factor is NOT the cash received.

You record Revenues when they are earned.

Revenues are considered earned either when we make the sale—when we sell the good—or when we perform the service.

Again, the receipt of cash is NOT the dictating, or determining, factor in when to record a Revenue.

So, you could have a situation where you get cash in advance.

If cash is received prior to earning and recording the Revenue, that cash is referred to as—we should know—Unearned Revenue. A Liability becomes a Revenue only when we do the work to earn it.

Of course, it could go the other way.

And, that is: we would actually make the sale, or perform the service, and not get paid until later. If that happens, the Revenue is still recorded when earned and we have an Account Receivable—money that is owed to us.

It is a key point:

Revenue is recorded when earned—when we either: sell the good or perform the service; not based on when we actually collect cash.

That is a key issue. That should be pretty much a review for us.

Please go to the next slide.

Slide 4

*Chapter 7 Module 1: Sales Revenue*

**Sales revenue represents revenue earned from selling inventory.**

**2 Adjustments to Sales Revenue:**

- 1. Sales Returns & Allowances**
- 2. Sales Discounts**

And, we have the Sales Revenue—it represents the selling price of the inventory sold to customers. It is on the Income Statement.

We also have two new accounts that we need to deal with—two accounts that are adjustments to the Sales Revenue.

We have what is called: the Sales Returns and Allowances. And, we have what is called: Sales Discounts.

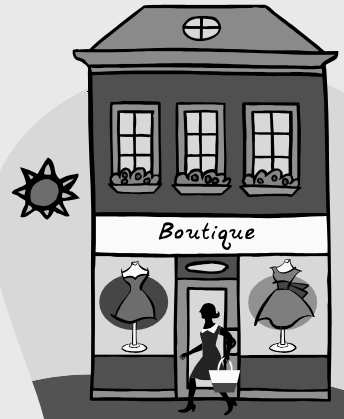
Let's spend a couple of minutes with each of these because they are new accounts that we have not seen and talk about what they mean.

Go to the next slide with me.

Slide 5

**Chapter 7 Module 1: Sales Returns & Allowances**

- Sales returns result when customers are dissatisfied with merchandise and are allowed to return the goods to the seller for credit or a refund.
- Sales allowances result when customers are dissatisfied with merchandise and the seller allows a reduction from the selling price. Goods are not returned in this case.



Sales Returns and Allowances consist of two things:

Sales Returns—something I think probably we are all pretty familiar with. When you buy goods from somebody, you get them home, and you say: “My goodness, what was I thinking?” And, the next day, you take the goods back to the seller.

They are goods that have been returned to the seller.

A Sales Allowance is a situation where the goods that are sold to the buyer maybe are not as high a quality as they should have been.

And, the seller says: “Well, look, I will give you a reduction in the selling price. I will reduce what you owe me.”

So, the buyer does not return the goods. Rather, they are given a reduction in the sales price and they can pay less for those goods.

A Sales Return is when the buyer is unhappy with the goods and they return it to the seller.

A Sales Allowance is when the buyer is unhappy with the goods but instead of returning it, they are given a reduction in the sales price of those goods.

I think Sales Returns and Allowances are really very straightforward as to what they are. There is really not a lot more to say about them.

But, if you go to the next slide...

**Slide 6**

*Chapter 7 Module 1: Sales Discounts*

- **Sales discounts**
  - **Offer of a cash discount to a credit customer for the prompt payment of a balance due**
  - **Example: 3/10, n/30**
    - This is read as ‘three, ten, net, thirty’
    - It means a 3% discount is allowed on all payments made within 10 days. After 10 days there is no discount available, and the remaining balance is due in 30 days.
  - **Reasons for offering sales discounts include:**
    - increase sales
    - speed up collection of cash
    - minimize the likelihood of bad debts

The one that does have a good bit to say about it is: Sales Discounts.

Sales Discounts:

Now, do not confuse it! It is not something like this. It is not: “Oh, hey, look! I work for Abercrombie & Fitch, so I get a 10% discount off of all of the clothes that I buy.”

That is not what a Sales Discount is.

A Sales Discount is an offer of a cash discount to a credit customer for the prompt payment, or the timely payment, of their bill.

So, a Sales Discount is an incentive to our credit customers to pay their bill early.

An example of a Sales Discount would be something like this:

And, you see the: 3 slash (/); 10 comma (,); N slash (/) 30 (3/10, n/30).

The way in which we read that Discount term: it is simply read as 3-10, net 30.

What it means—and, this is obviously more important—what it means is: “Hey, look credit customer, if you pay your bill within the first 10 days of purchase, you will get a 3% discount.”

That is the first part of the discount terms.

Anything you pay within the first 10 days, you get a 3% discount.

However, whatever has not been paid after 10 days of purchase is due in full within 30 days. There is no discount allowed.

Pay within 10 days, you get a 3% discount. Whatever has not been paid—the remainder—is due in full—no discount allowed—within 30 days.

Now, I have a question for you:

What would be some reasons that a company would offer Sales Discounts?

Why would we be willing to accept less than the selling price for these goods?

Why are we giving an incentive to somebody to pay us? Shouldn't the fact that: that is what they are supposed to do be incentive enough?

Why do we need to tack on an additional incentive?

There are lots of good reasons.

One: 1) it could increase our sales.

Maybe by offering discounts, more people will come to us rather than the competitor down the street because they can actually end up paying less for those goods if they pay promptly.

So, one good reason is 1) to try to increase our sales base.

Another good reason is 2) to speed up the collection of our cash.

Hey, look, we could have sales of 20 billion dollars! That is great! But without the cash, it does us no good! We need the cash in our hands as soon as possible.

One way to give an incentive to our customers to get us that money as quickly as possible is to offer them a discount for prompt payment.

The third one—an issue that we will spend a lot of time in this chapter dealing with—is: 3) to attempt to minimize the likelihood of bad debts—to attempt to minimize the likelihood of the customer not paying us at all.

So, there are lots of good reasons to offer a Sales Discount—there are three of them right there on the slide (Slide 6):

1) Increase our Sales, 2) Speed up our Cash Collections, and 3) Minimize the likelihood of our customers not paying us.

Please go to the next slide with me.

Slide 7

***Chapter 7 Module 1: Sales Revenue Adjustments***

**Characteristics of Sales Returns & Allowances and Sales Discounts:**

- **both accounts are classified as contra revenue accounts**
- **result in a decrease to revenues (specifically sales revenue) on the income statement**
- **normal balance = debit**

And, we have these two brand new accounts: Sales Returns and Allowances and Sales Discounts. Let's give some bullet-point characteristics to them because they are both of the same type and nature of accounts.

Both Sales Returns and Allowances and Sales Discounts are classified as Contra-Revenue accounts.

Contra-Revenue accounts: this means they result in a decrease (-) to revenues—specifically, Sales Revenue—on the Income Statement.

So, they are found on the Income Statement as a decrease (-) to our Sales Revenue.

The Contra-Revenue accounts carry a Normal Balance on the debit side—opposite of Revenue.

The Normal Balance for a Revenue is a credit. Hence, the Normal Balance for a Contra-Revenue is on the debit side.

Again, these are the sorts of characteristics you ought to be able to list out for every account we deal with.

Now, if you will please go to the next slide.

### Slide 8

<i>Chapter 7 Module 1: Income Statement</i>		
<b>Sales revenue</b>		<b>\$480,000</b>
<b>Less: Sales returns and allowance</b>	<b>\$12,000</b>	
<b>    Sales discounts</b>	<b><u>8,000</u></b>	<b><u>20,000</u></b>
<b>Net sales revenue</b>		<b>460,000</b>
<b>Cost of goods sold</b>		<b><u>316,000</u></b>
<b>Gross profit</b>		<b>144,000</b>
<b>Add: Other Revenues</b>		<b>45,000</b>
<b>Less: Other Expenses</b>		<b><u>19,000</u></b>
<b>Net income</b>		<b>170,000</b>

Let's look at what the Income Statement would appear like.

Remember: we have just added two new accounts.

You start with your Sale Revenue.

But, now we have two Contra-Revenues—two adjustments—Sales Returns and Sales Discounts.

So, you take your Sales Revenue. Subtract (-) the Returns and Discounts—the Contra-Revenues—this gives us what we call: Net Sales Revenue—in this case, \$480,000.

I have just made up these numbers for illustration purposes.

From our Net Sales Revenue, what are we going to subtract (-)?

We, of course, subtract (-) Cost of Goods Sold (CGS). That allows us to calculate Gross Profit—profit earned from selling a product.

We, of course, have to include (+) all other Revenues and then subtract (-) all other Expenses to get to Net Income.

The Income Statement—as we have seen from the very beginning of the class—except we have now added two new accounts—these Contra-Revenues—Sales Returns and Sales Discounts.

Please go to the next slide with me.

### Slide 9

<i>Chapter 7 Module 1: Example #1</i>			
<b><u>GENERAL JOURNAL</u></b>			
		<b>Debit</b>	<b>Credit</b>
<b>July 3</b>	<b>Accounts Receivable</b>	<b>10,000</b>	
	<b>Sales Revenue</b>		<b>10,000</b>
<b>To record sale of \$10,000 of inventory on account.</b>			
<hr/>			
<b><u>GENERAL JOURNAL</u></b>			
		<b>Debit</b>	<b>Credit</b>
<b>July 5</b>	<b>Sales Returns and Allowance</b>	<b>2,000</b>	
	<b>Accounts Receivable</b>		<b>2,000</b>
<b>To record return of goods delivered to ABC Company.</b>			

And, let's take a look at Example #1 from the Web site problems.

Let's see if we can put our new knowledge to test.

Here is what it says:

“On July 3, XYZ Company sold \$10,000 worth of merchandise to a customer on account. The Credit Terms were: 2/10, n/30. The customer returned \$2,000 of the goods two (2) days later—on July 5<sup>th</sup>—paid ½ of its remaining bill on July the 11<sup>th</sup>—the other ½ was paid July 29<sup>th</sup>.”

Let’s make the entries to record the transactions.”

Well, the first transaction:

On July 3<sup>rd</sup>, we made a credit sale.

This is one we should all be able to do.

We debit Accounts Receivable \$10,000; and we credit Sales Revenue to record a sale made on account. The Revenue is recorded independent of cash received.

On July 5<sup>th</sup>—two (2) days later—the customer brought back \$2,000 worth of the goods.

When a customer returns goods, we record that in the Sales Returns and Allowances.

We debit the Contra-Revenue account and we reduce their Accounts Receivable to reflect the fact that: they no longer owe us that money because they have returned the inventory purchased.

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## Slide 10

**Chapter 7 Module 1: Example #1**

<u>GENERAL JOURNAL</u>		Debit	Credit
July 11	Cash	3,920	
	Sales Discounts	80	
	Accounts Receivable		4,000

To record collection within the discount period.

$$\text{Discount} = (8,000 \times \frac{1}{2}) \times .02 = \$80$$

<u>GENERAL JOURNAL</u>		Debit	Credit
July 29	Cash	4,000	
	Accounts Receivable		4,000

To record collection after the discount period.

And, what happens next:

July the 11<sup>th</sup>: The customer paid ½ of its remaining bill.

NOTE: the first ½, or the first payment, is within the Discount period so we are able to offer them or they are able to take advantage of a discount.

To calculate it:

They owe us \$8,000. (Because: it started with \$10,000 and they returned \$2,000 worth of goods.) They owe us \$8,000. They paid ½ within the Discount period. And, they are given a 2% discount—a discount of \$80.00. They only have to send in cash of \$3,920.

We need to record the Sales Discount and reduce the Accounts Receivable by what has been decreased—1/2 of their balance.

The second payment—occurring on July 29<sup>th</sup>—is not within the Discount period—no discount is allowed. The customer must send in the entire \$4,000.

So, we will debit Cash and we will credit Accounts Receivable.

Now, notice: the differences here in recording cash received within a Discount period versus (vs.) outside of the Discount period.

You need to worry about that Contra-Revenue: Sales Discounts.