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## chapter 6

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# Reporting and Interpreting Sales Revenue, Receivables, and Cash

Founded by then University of California, Santa Barbara, student Doug Otto, Deckers Outdoor is best known for its Teva sports sandals and UGG sheepskin boots. Deckers has become a major player in the casual, outdoor, and athletic footwear market by building on the needs of hikers, trail runners, kayakers, surfers, and whitewater rafters for comfort, function, and performance. Its growth strategy requires building brand recognition by developing and introducing additional innovative footwear that satisfies the company's high standards. "Building the brands" allows Deckers to maintain a loyal consumer following and penetrate new markets. It also has allowed Deckers to continue to grow during the worst recession in more than 25 years.

There is a second key component to Deckers's successful growth strategy. Success in the ultracompetitive footwear market requires careful matching of production schedules to customers' needs and careful management of customer receivables. Deckers's successful focus on brand development, product innovation, and working capital management has allowed the company to report the highest gross profit and net income in its history.

## Learning Objectives

**After studying this chapter, you should be able to:**

- 6-1** Apply the revenue realization principle to determine the accepted time to record sales revenue for typical retailers, wholesalers, manufacturers, and service companies. p. 278
- 6-2** Analyze the impact of credit card sales, sales discounts, and sales returns on the amounts reported as net sales. p. 279
- 6-3** Estimate, report, and evaluate the effects of uncollectible accounts receivable (bad debts) on financial statements. p. 283
- 6-4** Analyze and interpret the receivables turnover ratio and the effects of accounts receivable on cash flows. p. 290

**6-5** Report, control, and safeguard cash. p. 293

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FOCUS COMPANY:

## Deckers Outdoor Corporation\*

BUILDING BRANDS TO BUILD  
GROSS PROFIT: MANAGING  
PRODUCT DEVELOPMENT,  
PRODUCTION, AND WORKING  
CAPITAL

[www.deckers.com](http://www.deckers.com)

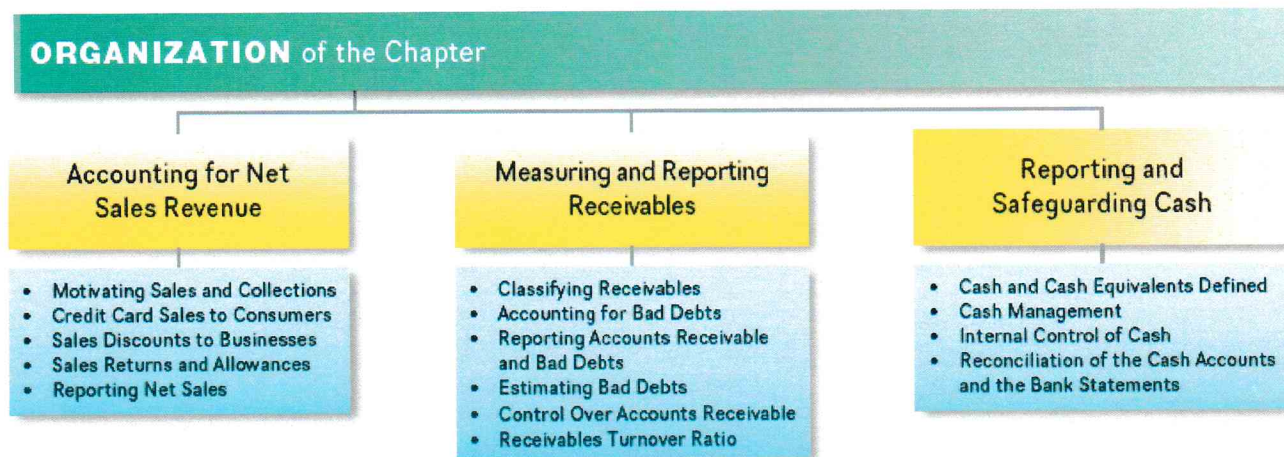
## UNDERSTANDING THE BUSINESS

Planning Deckers's growth strategy requires careful coordination of sales activities, as well as cash collections from customers. Much of this coordination revolves around allowing consumers to use credit cards, providing business customers discounts for early payment, and allowing sales returns and allowances under certain circumstances—strategies that motivate customers to buy its products and make payment for their purchases. These activities affect **net sales** revenue, the top line on the income statement. Coordinating sales and cash collections from customers also involves managing bad debts, which affect selling, general, and administrative expenses on the income statement and **cash** and **accounts receivable** on the balance sheet. Net sales, accounts receivable, and cash are the focus of this chapter. We will also introduce the receivables turnover ratio as a measure of the efficiency of credit-granting and collection activities. Finally, since the cash collected from customers is also a tempting target for fraud and embezzlement, we will discuss how accounting systems commonly include controls to prevent and detect such misdeeds.

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## ACCOUNTING FOR NET SALES REVENUE

### LEARNING OBJECTIVE 6-1

Apply the revenue realization principle to determine the accepted time to record sales revenue for typical retailers, wholesalers, manufacturers, and service companies.

As indicated in Chapter 3, the **revenue realization principle** requires that revenues be recorded when they are earned (delivery has occurred or services have been rendered, there is persuasive evidence of an arrangement for customer payment, the price is fixed or determinable, and collection is reasonably assured). For sellers of goods, these criteria are most often met and sales revenue is recorded when title and risks of ownership transfer to the buyer.<sup>1</sup> The point at which title (ownership) changes hands is determined by the shipping terms in the sales contract. When goods are shipped **FOB (free on board) shipping point**, title changes hands at shipment, and the buyer normally pays for shipping. When they are shipped **FOB destination**, title changes hands on delivery, and the seller normally pays for shipping. Revenues from goods shipped FOB shipping point are normally recognized at shipment. Revenues from goods shipped FOB destination are normally recognized at delivery.

Service companies most often record sales revenue when they have provided services to the buyer. Companies disclose the revenue recognition rule they follow in the footnote to the financial statements entitled Summary of Significant Accounting Policies. In that note, Deckers reports the following:

**DECKERS**  
outdoor corporation

REAL WORLD EXCERPT  
Annual Report

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. Summary of Significant Accounting Policies

#### *Revenue Recognition*

The Company recognizes wholesale, eCommerce, and international distributor revenue when products are shipped and retail revenue at the point of sale. All sales are recognized when the customer takes title and assumes risk of loss, collection of relevant receivable is reasonably assured, persuasive evidence of an arrangement exists, and the sales price is fixed or determinable.

The appropriate **amount** of revenue to record is the **cash equivalent sales price**.

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## Motivating Sales and Collections

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Some sales practices differ depending on whether sales are made to businesses or consumers. Deckers sells footwear and apparel to other **businesses** (retailers), including Athlete's Foot and Eastern Mountain Sports, which then sell the goods to consumers. It also operates its own Internet and retail stores that sell footwear directly to **consumers**.

Deckers uses a variety of methods to motivate both groups of customers to buy its products and make payment for their purchases. The principal methods include (1) allowing consumers to use credit cards to pay for purchases, (2) providing business customers direct credit and discounts for early payment, and (3) allowing returns from all customers under certain circumstances. These methods, in turn, affect the way we compute **net sales revenue**.

## Credit Card Sales to Consumers

### LEARNING OBJECTIVE 6-2

Analyze the impact of credit card sales, sales discounts, and sales returns on the amounts reported as net sales.

Deckers accepts cash or credit card payment for its retail store and Internet sales. Deckers's managers decided to accept credit cards (mainly Visa, Mastercard, and American Express) for a variety of reasons:

1. Increasing customer traffic.
2. Avoiding the costs of providing credit directly to consumers, including recordkeeping and bad debts (discussed later).
3. Lowering losses due to bad checks.
4. Avoiding losses from fraudulent credit card sales. (As long as Deckers follows the credit card company's verification procedure, the credit card company [e.g., Visa] absorbs any losses.)
5. Receiving money faster. (Since credit card receipts can be directly deposited in its bank account, Deckers receives its money faster than it would if it provided credit directly to consumers.)

A **CREDIT CARD DISCOUNT** is the fee charged by the credit card company for its services.

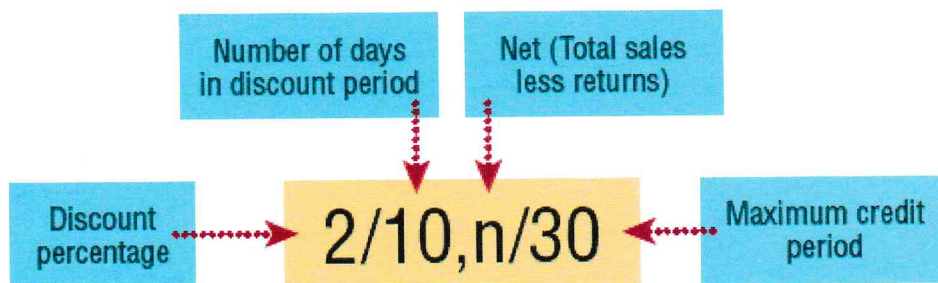
The credit card company charges a fee for the service it provides. When Deckers deposits its credit card receipts in the bank, it might receive credit for only 97 percent of the sales price. The credit card company is charging a 3 percent fee (the **credit card discount**) for its services. If daily credit card sales were \$3,000, Deckers would report the following:

Sales revenue	\$3,000
Less: Credit card discounts ( $0.03 \times 3,000$ )	<u>90</u>
Net sales (reported on the income statement)	\$2,910

## Sales Discounts to Businesses

Most of Deckers's sales to businesses are credit sales on open account; that is, there is no formal written promissory note or credit card. When Deckers sells footwear to retailers on credit, credit terms are printed on the sales document and invoice (bill) sent to the customer. Often credit terms are abbreviated. For example, if the full price is due within 30 days of the invoice date, the credit terms would be noted as **n/30**. Here, the **n** means the sales amount **net** of, or less, any sales returns.

### Early Payment Incentive



A **SALES DISCOUNT** (cash discount) is a cash discount offered to encourage prompt payment of an account receivable.

In some cases, a **sales discount** (often called a cash discount) is granted to the purchaser to encourage early payment.<sup>2</sup> For example, Deckers may offer terms of 2/10, n/30, which means that the customer may deduct 2 percent from the invoice price if cash payment is made within 10 days from the date of sale. If cash payment is not made within the 10-day discount period, the full sales price (less any returns) is due within a maximum of 30 days.

Deckers offers this sales discount to encourage customers to pay more quickly. This provides two benefits to Deckers:

1. Prompt receipt of cash from customers reduces the necessity to borrow money to meet operating needs.
2. 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 Deckers's bill is paid.

Companies commonly record sales discounts taken by subtracting the discount from sales if payment is made **within** the discount period (the usual case).<sup>3</sup> For example, if credit sales of \$1,000 are recorded with terms 2/10, n/30 and payment of \$980 ( $\$1,000 \times 0.98 = \$980$ ) is made within the discount period, net sales of the following amount would be reported:

Sales revenue	\$1,000
Less: Sales discounts ( $0.02 \times \$1,000$ )	20
Net sales (reported on the income statement)	\$ 980

If payment is made after the discount period, the full \$1,000 would be reported as net sales. Accounting for sales discounts is discussed in more detail in the Supplement at the end of this chapter.

## FINANCIAL ANALYSIS



## To Take or Not to Take the Discount, That Is the

### Question

Customers usually pay within the discount period because the savings are substantial. With terms 2/10, n/30, customers save 2 percent by paying 20 days early (on the 10th day instead of the 30th). This translates into a 37 percent annual interest rate. To calculate the annual interest rate, first compute the interest rate for the discount period. When the 2 percent discount is taken, the customer pays only 98 percent of the gross sales price. For example, on a \$100 sale with terms 2/10, n/30, \$2 would be saved and \$98 would be paid 20 days early.

The interest rate for the 20-day discount period and the annual interest rate are computed as follows:

$$\frac{\text{Amount Saved}}{\text{Amount Paid}} = \text{Interest Rate for 20 Days} \quad \text{Interest Rate for 20 Days} \times \frac{365 \text{ days}}{20 \text{ days}} = \text{Annual Interest Rate}$$

$$\frac{\$2}{\$98} = 2.04\% \text{ for 20 Days} \quad 2.04\% \times \frac{365 \text{ days}}{20 \text{ days}} = 37.23\% \text{ Annual Interest Rate}$$

As long as the bank's interest rate is less than the interest rate associated with failing to take cash discounts, the customer will save by taking the cash discount. For example, even if credit customers had to borrow from that bank at a high rate such as 15 percent, they would save a great deal.

## Sales Returns and Allowances

**SALES RETURNS AND ALLOWANCES** is a reduction of sales revenues for return of or allowances for unsatisfactory goods.

Retailers and consumers have a right to return unsatisfactory or damaged merchandise and receive a refund or an adjustment to their bill. Such returns are often accumulated in a separate account called **Sales Returns and Allowances** and must be deducted from gross

sales revenue in determining net sales. This account informs Deckers's managers of the volume of returns and allowances and thus provides an important measure of the quality of customer service. Assume that Fontana Shoes of Ithaca, New York, buys 40 pairs of sandals (at \$50 each) from Deckers for \$2,000 on account. Before paying for the sandals, Fontana discovers that 10 pairs of sandals are not the color ordered and returns them to Deckers.<sup>4</sup> Deckers computes net sales as follows:

Sales revenue	\$2,000
Less: Sales returns and allowances (10 × \$50)	<u>500</u>
Net sales (reported on the income statement)	\$1,500

Cost of goods sold related to the 10 pairs of sandals would also be reduced.

## Reporting Net Sales

On the company's books, credit card discounts, sales discounts, and sales returns and allowances are accounted for separately to allow managers to monitor the costs of credit card use, sales discounts, and returns. Using the numbers in the preceding examples, the amount of net sales reported on the income statement is computed in the following manner:

Sales revenue	\$6,000
Less: Credit card discounts (a contra-revenue)	90
Sales discounts (a contra-revenue)	20
Sales returns and allowances (a contra-revenue)	<u>500</u>
Net sales (included on the first line of the income statement)	\$5,390

**NET SALES** is the top line reported on the income statement. It is computed as follows:

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

**Net sales** to all customers is the top line reported on Deckers's income statement, presented in Exhibit 6.1. Deckers indicates in its revenue recognition footnote that the appropriate subtractions are made.

**DECKERS OUTDOOR CORPORATION AND SUBSIDIARIES**  
**Consolidated Statements of Operations**  
**Three Years Ended December 31, 2011, 2010, 2009**  
(amounts in thousands except per share data)

EXHIBIT 6.1

Net Sales on the Income  
Statement

**DECKERS**  
outdoor corporation  
REAL WORLD EXCERPT  
Annual Report

	2011	2010	2009
Net sales	\$1,377,283	\$1,000,989	\$813,177
Cost of sales	<u>698,288</u>	<u>498,051</u>	<u>442,087</u>
Gross profit	678,995	502,938	371,090
Selling, general, and administrative expenses	<u>394,157</u>	<u>253,850</u>	<u>189,843</u>
Income from operations	284,838	249,088	181,247
Interest income (expense)	<u>424</u>	<u>1,021</u>	<u>1,976</u>
Income before income taxes	285,262	250,109	183,223
Income taxes	<u>83,404</u>	<u>89,732</u>	<u>66,304</u>
Net income	<u>\$ 201,858</u>	<u>\$ 160,377</u>	<u>\$116,919</u>

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DECKERS OUTDOOR CORPORATION AND SUBSIDIARIES  
**Consolidated Statements of Operations**  
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Net Sales on the Income  
Statement

**DECKERS**  
outdoor corporation

REAL WORLD EXCERPT  
Annual Report

**DECKERS**  
outdoor corporation  
REAL WORLD EXCERPT  
Annual Report

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

*Revenue Recognition*

... allowances for estimated returns, discounts ... are provided for when related revenue is recorded.

In 2014, Deckers disclosed that it provided its customers with \$24,075,000 in sales discounts based on meeting certain order, shipment, and payment timelines.



PAUSE FOR FEEDBACK

**DECKERS**  
outdoor corporation

In the last section, we learned to analyze the impact of **credit card sales, sales discounts, and sales returns**, all of which reduce the amounts reported as net sales. Both credit card discounts and sales or cash discounts promote faster receipt of cash. Sales returns and allowances include refunds and adjustments to customers' bills for defective or incorrect merchandise.

Before you move on, complete the following questions to test your understanding of these concepts.

**SELF-STUDY QUIZ**

1. Assume that Deckers sold \$30,000 worth of footwear to various retailers with terms 1/10, n/30 and half of that amount was paid within the discount period. Gross catalog and Internet sales were \$5,000 for the same period; 80 percent of these sales were paid for with credit cards with a 3 percent discount and the rest were paid for with cash. Compute net sales for the period.  
\_\_\_\_\_  
\_\_\_\_\_

2. During the first quarter of 2011, Deckers's net sales totaled \$204,851, and cost of sales was \$102,373. What was Deckers's gross profit for 2011?  
\_\_\_\_\_  
\_\_\_\_\_

*After you have completed your answers, check them with the solutions at the bottom of the page.*

Solutions to SELF-STUDY QUIZ

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1. Gross Sales		\$35,000
Less: Sales Discounts ( $0.01 \times 1/2 \times \$30,000$ )		150
Credit Card Discounts ( $0.03 \times 0.80 \times \$5,000$ )		<u>120</u>
Net Sales		<u>\$34,730</u>

2. Net Sales	\$204,851
Cost of Sales	<u>102,373</u>
Gross Profit	<u>\$102,478</u>

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## MEASURING AND REPORTING RECEIVABLES

### Classifying Receivables

**ACCOUNTS RECEIVABLE** (Trade Receivables, Receivables) are open accounts owed to the business by trade customers.

**NOTES RECEIVABLE** are written promises that require another party to pay the business under specified conditions (amount, time, interest).

Receivables may be classified in three common ways. First, they may be classified as either an account receivable or a note receivable. An **account receivable** is created by a credit sale on an open account. For example, an account receivable is created when Deckers sells shoes on open account to Fontana Shoes in Ithaca, New York. A **note receivable** is a promise in writing (a formal document) to pay (1) a specified amount of money, called the **principal**, at a definite future date known as the maturity date and (2) a specified amount of **interest** at one or more future dates. The interest is the amount charged for use of the principal.

Second, receivables may be classified as trade or nontrade receivables. A **trade receivable** is created in the normal course of business when a sale of merchandise or services on credit occurs. A **nontrade receivable** arises from transactions other than the normal sale of merchandise or services. For example, if Deckers loaned money to a new vice president to help finance a home at the new job location, the loan would be classified as a nontrade receivable. Third, in a classified balance sheet, receivables also are classified as either **current** or **noncurrent** (short term or long term), depending on when the cash is expected to be collected. Like many companies, Deckers reports only one type of receivable account, Trade Accounts Receivable, from customers and classifies the asset as a current asset because the accounts receivable are all due to be paid within one year.

#### INTERNATIONAL PERSPECTIVE



#### Foreign Currency Receivables

Export (international) sales are a growing part of the U.S. economy. For example, international sales amounted to 31.4 percent of Deckers's revenues in 2011. Most export sales to businesses are on credit. When a buyer agrees to pay in its local currency, Deckers cannot add the resulting accounts receivable, which are denominated in foreign currency, directly to its U.S. dollar accounts receivable. Deckers's accountants must first convert them to U.S. dollars using the end-of-period exchange rate between the two currencies. For example, if a French department store owed Deckers €20,000 (euros, the common currency of the European Monetary Union) on December 31, 2011, and each euro was worth US\$1.29 on that date, it would add US\$25,800 to its accounts receivable on the balance sheet.

Selected Foreign  
Currency Exchange Rates  
(in US\$)

Mexican Peso \$0.08

Singapore Dollar \$0.80

Euro \$1.29

## Accounting for Bad Debts

### LEARNING OBJECTIVE 6-3

Estimate, report, and evaluate the effects of uncollectible accounts receivable (bad debts) on financial statements.

For billing and collection purposes, Deckers keeps a separate accounts receivable account for each retailer that resells its footwear and apparel (called a **subsidiary account**). The accounts receivable amount on the balance sheet represents the total of these individual customer accounts.

When Deckers extends credit to its commercial customers, it knows that some of these customers will not pay their debts. The expense matching principle requires recording of bad debt expense in the **same** accounting period in which the related sales are made. This presents an important accounting problem. Deckers may not learn which particular customers will not pay until the **next** accounting period. So, at the end of the period of sale, it normally does not know which customers' accounts receivable are bad debts.

The **ALLOWANCE METHOD** bases bad debt expense on an estimate of uncollectible accounts.

Deckers resolves this problem by using the **allowance method** to measure bad debt expense. The allowance method is based on **estimates** of the expected amount of bad debts. Two primary steps in employing the allowance method are:

1. Making the end-of-period adjusting entry to record estimated bad debt expense.
2. Writing off specific accounts determined to be uncollectible during the period.

## Recording Bad Debt Expense Estimates

**BAD DEBT EXPENSE** (Doubtful Accounts Expense, Uncollectible Accounts Expense, Provision for Uncollectible Accounts) is the expense associated with estimated uncollectible accounts receivable.

**Bad debt expense** (doubtful accounts expense, uncollectible accounts expense, provision for uncollectible accounts) is the expense associated with estimated uncollectible accounts receivable. An **adjusting journal entry at the end of the accounting period** records the bad debt estimate. For the year ended December 31, 2011, Deckers estimated bad debt expense to be \$75,995 (all numbers in thousands of dollars) and made the following adjusting entry:

Bad debt expense (+E, -SE) .....	75,995	
Allowance for doubtful accounts (+XA, -A) .....		75,995

Assets	=	Liabilities	+	Stockholders' Equity
Allowance for doubtful accounts		-75,995		Bad debt expense (+E)      -75,995

**ALLOWANCE FOR DOUBTFUL ACCOUNTS** (Allowance for Bad Debts, Allowance for Uncollectible Accounts) is a contra-asset account containing the estimated uncollectible accounts receivable.

The Bad Debt Expense is included in the category “Selling” expenses on the income statement. It decreases net income and stockholders’ equity. Accounts Receivable could not be credited in the journal entry because there is no way to know which customers’ accounts receivable are involved. So the credit is made, instead, to a contra-asset account called **Allowance for Doubtful Accounts** (Allowance for Bad Debts or Allowance for Uncollectible Accounts). As a contra-asset, the balance in Allowance for Doubtful Accounts is always subtracted from the balance of the asset Accounts

Receivable. Thus, the entry decreases the net book value of Accounts Receivable and total assets.

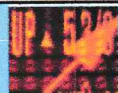
### Writing Off Specific Uncollectible Accounts

**Throughout the year**, when it is determined that a customer will not pay its debts (e.g., due to bankruptcy), the write-off of that individual bad debt is recorded through a journal entry. Now that the specific uncollectible customer account receivable has been identified, it can be removed with a credit. At the same time, we no longer need the related estimate in the contraasset Allowance for Doubtful Accounts, which is removed by a debit. The journal entry summarizing Deckers's total write-offs of \$68,075 during 2011 follows:

Allowance for doubtful accounts (-XA, +A) .....	68,075
Accounts receivable (-A) .....	68,075

Assets	=	Liabilities	+	Stockholders' Equity
Allowance for doubtful accounts +68,075				
Accounts receivable -68,075				

Notice that this journal entry did **not affect any income statement accounts**. It did not record a bad debt expense because the estimated expense was recorded with an adjusting entry in the period of sale. Also, the entry did **not change the net book value of accounts receivable**, since the decrease in the asset account (Accounts Receivable) was offset by the decrease in the contra-asset account (Allowance for Doubtful Accounts). Thus, it also did not affect total assets.



When a company receives a payment on an account that has already been written off, the journal entry to write off the account is reversed to put the receivable back on the books, and the collection of cash is recorded. For example, if the previously written off amount was \$677, it would make the following entries:

Accounts receivable (+A) .....	677	
Allowance for doubtful accounts (+XA, -A) .....		677
Cash (+A) .....	677	
Accounts receivable (-A) .....		677

Note that these entries, like the original write-off, do not affect total assets or net income. Only the estimate of bad debts affects these amounts.

## Summary of the Accounting Process

It is important to remember that accounting for bad debts is a two-step process:

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) ↓	

Deckers's complete 2011 accounting process for bad debts can now be summarized in terms of the changes in Accounts Receivable (Gross) and the Allowance for Doubtful Accounts:<sup>5</sup>

Accounts Receivable (Gross) (A)			
Beginning balance	130,435	Collections on account	1,224,576
Sales on account	1,377,283	Write-offs	68,075
Ending balance	<u>215,067</u>		

Allowance for Doubtful Accounts (XA)			
Write-offs	68,075	Beginning balance	13,772
		Bad debt expense adjustment	75,995
		Ending balance	<u>21,692</u>

Accounts Receivable Dec. 31, 2011	
Accounts Receivable (Gross) (A)	\$215,067
Allowance for Doubtful Accounts (XA)	21,692
Accounts Receivable (Net) (A)	\$193,375

Accounts Receivable (Gross) includes the total accounts receivable, both collectible and uncollectible. The balance in the Allowance for Doubtful Accounts is the portion of the accounts receivable balance the company estimates to be uncollectible. Accounts Receivable (Net) reported on the balance sheet is the portion of the accounts the company expects to collect (or its estimated net realizable value).

## Reporting Accounts Receivable and Bad Debts

Analysts who want information on Deckers's receivables will find Accounts Receivable, net of allowance for doubtful accounts (the **net book value**), of \$193,375 and \$116,663 for 2011 and 2010, respectively, reported on the balance sheet (Exhibit 6.2). Deckers reports the balance in the Allowance for Doubtful Accounts (\$21,692 in 2011 and \$13,772 in 2010) within the account title. Other companies report the balance in the Allowance for Doubtful Accounts in a note. Accounts Receivable (Gross), the total accounts receivable, can be computed by adding the two amounts together.

The amounts of bad debt expense and accounts receivable written off for the period, if material, are reported on a schedule that publicly traded companies must include in their Annual Report Form 10-K filed with the SEC. Exhibit 6.3 presents this schedule from Deckers's 2011 filing.

EXHIBIT 6.2		DECKERS OUTDOOR CORPORATION AND SUBSIDIARIES		
Accounts Receivable on the Partial Balance Sheet  <b>DECKERS</b> outdoor corporation  REAL WORLD EXCERPT Annual Report		Consolidated Balance Sheets		
		December 31, 2011 and 2010		
		(amounts in thousands of dollars except share data)		
		2011	2010	
<b>Assets</b>				
Current assets:				
	Cash and cash equivalents	\$263,606	\$445,226	
	Trade accounts receivable, net of allowances of \$21,692 and \$13,772 in 2011 and 2010, respectively	193,375	116,663	
	Inventories	253,270	124,995	
	Prepaid expenses	8,697	7,928	
	Other current assets	84,540	8,918	
	Deferred tax assets	14,414	12,002	
	Total current assets	\$817,902	\$715,732	

EXHIBIT 6.3

Accounts Receivable Valuation  
Schedule (Form 10-K)

**DECKERS**  
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REAL WORLD EXCERPT  
Annual Report

**DECKERS OUTDOOR CORPORATION AND SUBSIDIARIES**

Valuation and Qualifying Accounts  
Three Years Ended December 31, 2011, 2010, and 2009

Description	Balance at Beginning of Year	Additions	Deductions	Balance at End of Year
Allowance for doubtful account year ended:				
December 31, 2011	\$13,772	\$75,995	\$68,075	\$21,692
December 31, 2010	11,790	46,224	44,242	13,772
December 31, 2009	10,706	40,620	39,536	11,790



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**crocs**  
© Crocs, Inc.

When receivables are material, companies must employ the allowance method to account for uncollectibles. These are the steps in the process:

- a. The end-of-period adjusting entry to record the estimate of bad debt expense and *increase* the allowance for doubtful accounts.
- b. Writing off specific accounts determined to be uncollectible during the period to eliminate the specific uncollectible account receivable and *decrease* the allowance for doubtful accounts.

The adjusting entry reduces net income as well as net accounts receivable. The write-off affects neither. Before you move on, complete the following questions to test your understanding of these concepts.

### SELF-STUDY QUIZ

In a recent year, Crocs, Inc., a major Deckers competitor, had a beginning credit balance in the Allowance for Doubtful Accounts of \$3,973 (all numbers in thousands of dollars). It wrote off accounts receivable totaling \$1,535 during the year and made a bad debt expense adjustment for the year of \$2,204.

1. What adjusting journal entry did Crocs make for bad debts at the end of the year?
2. Make the journal entry summarizing Crocs's total write-off of bad debts during the year.
3. Compute the balance in the Allowance for Doubtful Accounts at the end of the year.

*After you have completed your answers, check them with the solutions at the bottom of the page.*

### GUIDED HELP



[www.mhhe.com/libby8e](http://www.mhhe.com/libby8e)

For additional step-by-step video instruction on preparing journal entries related to bad debts, go to the URL or scan the QR code in the margin with your smartphone or iPad.

## Estimating Bad Debts

The bad debt expense amount recorded in the end-of-period adjusting entry often is estimated based on either (1) a percentage of total credit sales for the period or (2) an aging of accounts receivable. Both methods are acceptable under GAAP and are widely used. The percentage of credit sales method is simpler to apply, but the aging method is generally more accurate. Many companies use the simpler method on a weekly or monthly basis and use the more accurate method on a monthly or quarterly basis to check the accuracy of the earlier estimates. In our example, both methods produce exactly the same estimate, which rarely occurs in practice.

### Percentage of Credit Sales Method

The **PERCENTAGE OF CREDIT SALES METHOD** bases bad debt expense on the historical percentage of credit sales that result in bad debts.

The **percentage of credit sales method** bases bad debt expense on the historical percentage of credit sales that result in bad debts. The average percentage of credit sales that result in bad debts can be computed by dividing total bad debt losses by total **credit** sales. A company that has been operating for some years has sufficient experience to project probable future bad debt losses. For example, if we assume that, during the year 2012, Deckers expected bad debt losses of 1.0 percent of credit sales, and its credit sales were \$1,500,000, it would estimate the current year's bad debts as:

---

#### Solutions to SELF-STUDY QUIZ

1. Bad debt expense (+E, -SE)	2,204	
Allowance for doubtful accounts (+XA, -A)		2,204
2. Allowance for doubtful accounts (-XA, +A)	1,535	
Accounts receivable (-A)		1,535
3. Beginning Balance + Bad Debt Expense Estimate - Write-Offs = Ending Balance.		
\$3,973 + 2,204 - 1,535 = \$4,642		

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Credit sales	\$1,500,000
× Bad debt loss rate (1.0%)	× .01
<b>Bad debt expense</b>	<b>\$ 15,000</b>

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This amount would be directly recorded as Bad Debt Expense (and an increase in Allowance for Doubtful Accounts) in the current year. Our beginning balance in the Allowance for Doubtful Accounts for 2012 would be the ending balance for 2011. Assuming write-offs during 2012 of \$13,692, the ending balance is computed as follows:

		Allowance for Doubtful Accounts (XA)	
Beginning balance	\$21,692	2012 Write-offs	13,692
+ Bad debt expense	15,000	2012 Beginning balance	21,692
– Write-offs	13,692	2012 Bad debt expense adjustment	<u>15,000</u>
Ending balance	<u>\$23,000</u>	2012 Ending balance	? = 23,000

## Aging of Accounts Receivable

The **AGING OF ACCOUNTS RECEIVABLE METHOD** estimates uncollectible accounts based on the age of each account receivable.

The **aging of accounts receivable method** relies on the fact that, as accounts receivable become older and more overdue, it is less likely that they will be collected. For example, a receivable that was due in 30 days but has not been paid after 120 days is less likely to be collected, on average, than a similar receivable that remains unpaid after 45 days.

If Deckers split its assumed 2012 ending balance in accounts receivable (gross) of \$230,000 into three age categories, it would first examine the individual customer accounts receivable and sort them into the three age categories. Based on prior experience, management would then **estimate** the probable bad debt loss rates for each category: for example, not yet due, 2 percent; 1 to 90 days past due, 10 percent; over 90 days, 30 percent.

As illustrated in the aging schedule below, this would result in an estimate of total uncollectible amounts of \$23,000, the **estimated ending balance** that **should be** in the Allowance for Doubtful Accounts. From this, the adjustment to record Bad Debt Expense (and an increase in Allowance for Doubtful Accounts) for 2012 would be computed as follows:

## Aging Schedule 2012

Aged Accounts Receivable		Estimated Percentage Uncollectible	Estimated Amount Uncollectible
Not yet due	\$115,000	×	2% = \$ 2,300
Up to 90 days past due	69,000	×	10% = 6,900
Over 90 days past due	46,000	×	30% = 13,800
Estimated ending balance in Allowance for Doubtful Accounts			\$23,000
Less: Balance in Allowance for Doubtful Accounts before adjustment (21,692 - 13,692)			8,000
Bad Debt Expense for the year			<u>\$15,000</u>

Allowance for Doubtful Accounts (XA)			
		2012 Beginning balance	21,692
2012 Write-offs	13,692	2012 Bad debt expense adjustment	?
		2012 Ending balance	<u>23,000</u>

= 15,000 ←

Total estimated uncollectible accounts ←

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Comparison of the Two Methods

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**Students often fail to recognize that the approach to recording bad debt expense using the percentage of credit sales method is different from that for the aging method:**

- **Percentage of credit sales.** Directly compute the amount to be recorded as **Bad Debt Expense** on the **income statement** for the period in the adjusting journal entry.
- **Aging of Accounts Receivable.** Compute the **estimated ending balance** we would like to have in the **Allowance for Doubtful Accounts** on the **balance sheet** after we make the necessary adjusting entry. The **difference** between the current balance in the account and the estimated balance is recorded as the adjusting entry for Bad Debt Expense for the period.

In either case, the balance sheet presentation for 2012 would show Accounts Receivable, less Allowance for Doubtful Accounts, of \$207,000 (\$230,000 – \$23,000).

### Actual Write-Offs Compared with Estimates

Deckers's Form 10-K provides particularly clear information on its approach to estimating uncollectible accounts and the potential effect of any errors in those estimates:

#### CRITICAL ACCOUNTING POLICIES

##### *Allowance for Doubtful Accounts*

We provide a reserve against trade accounts receivable for estimated losses that may result from customers' inability to pay. We determine the amount of the reserve by analyzing known uncollectible accounts, aged trade accounts receivables, economic conditions and forecasts, historical experience and the customers' credit-worthiness. . . . Our use of different estimates and assumptions could produce different financial results. For example, a 1.0% change in the rate used to estimate the reserve for the accounts we consider to have credit risk and not specifically identified as uncollectible would change the allowance for doubtful accounts by \$1,100.

**DECKERS**  
outdoor corporation

REAL WORLD EXCERPT  
Form 10-K

If uncollectible accounts actually written off differ from the estimated amount previously recorded, a higher or lower amount is recorded in the next period to make up for the previous period's error in estimate. **When estimates are found to be incorrect, financial statement values for prior annual accounting periods are not corrected.**

### Control Over Accounts Receivable

Many managers forget that extending credit will increase sales volume, but unless the related receivables are collected, they do not add to the bottom line. Companies that emphasize sales without monitoring the collection of credit sales soon find much of their current assets tied up in accounts receivable. The following practices can help minimize bad debts:

1. Require approval of customers' credit history by a person independent of the sales and collections functions.

2. Age accounts receivable periodically and contact customers with overdue payments.
3. Reward both sales and collections personnel for speedy collections so that they work as a team.

To assess the effectiveness of overall credit-granting and collection activities, managers and analysts often compute the receivables turnover ratio.

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## KEY RATIO ANALYSIS



## Receivables Turnover Ratio

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**? ANALYTICAL QUESTION**

How effective are credit-granting and collection activities?

**% RATIO AND COMPARISONS**

The receivables turnover ratio is computed as follows (see Exhibits 6.1 and 6.2):

$$\text{Receivables Turnover} = \frac{\text{Net Sales}^*}{\text{Average Net Trade Accounts Receivable}^\dagger}$$

The 2011 receivables turnover ratio for Deckers:

$$\frac{\$1,377,283}{(116,663 + 193,375)/2} = 8.9$$

COMPARISONS OVER TIME			COMPARISONS WITH COMPETITORS	
Deckers			Skechers U.S.A.	Crocs
2009	2010	2011	2011	2011
8.8	10.4	8.9	7.3	13.4

**💡 INTERPRETATIONS**

**In General** The receivables turnover ratio reflects how many times average trade receivables are recorded and collected during the period. The higher the ratio, the faster the collection of receivables. A higher ratio benefits the company because it can invest the money collected to earn interest income or reduce borrowings to reduce interest expense. Overly generous payment schedules and ineffective collection methods keep the receivables turnover ratio low. Analysts and creditors watch this ratio because a sudden decline may mean that a company is extending payment deadlines in an attempt to prop up lagging sales or is even recording sales that will later be returned by customers. Many managers and analysts compute the related number **average collection period** or **average days sales in receivables**, which is equal to  $365 \div \text{Receivables Turnover Ratio}$ . It indicates the average time it takes a customer to pay its accounts. For Deckers, the amount would be computed as follows for 2011:

$$\text{Average Collection Period} = \frac{365}{\text{Receivables Turnover}} = \frac{365}{8.9} = 41.0 \text{ days}$$

**Focus Company Analysis** Deckers's receivables turnover increased from a 2009 low of 8.8 to 8.9 in 2011. This indicates that the company is taking less time to convert its receivables into cash. Compared to the receivables turnover ratios of its competitors, Deckers's ratio is above that of Skechers and below that of Crocs.

**A Few Cautions** Since differences across industries and between firms in the manner in which customer purchases are financed can cause dramatic differences in the ratio, a particular firm's ratio should be compared only with its prior years' figures or with other firms in the same industry following the same financing practices.

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## FOCUS ON CASH FLOWS



## Accounts Receivable

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The change in accounts receivable can be a major determinant of a company's cash flow from operations. While the income statement reflects the revenues of the period, the cash flow from operating activities reflects cash collections from customers. Since sales on account increase the balance in accounts receivable and cash collections from customers decrease the balance in accounts receivable, the change in accounts receivable from the beginning to the end of the period is the difference between sales and collections.

### EFFECT ON STATEMENT OF CASH FLOWS

**In General** When there is a net **decrease in accounts receivable** for the period, cash collected from customers is more than revenue; thus, the decrease must be **added** in computing cash flows from operations. When a net **increase in accounts receivable** occurs, cash collected from customers is less than revenue; thus, the increase must be **subtracted** in computing cash flows from operations.\*

	Effect on Cash Flows
<b>Operating activities</b> (indirect method)	
Net income	\$ xxx
Adjusted for	
Add accounts receivable decrease	+
or	
Subtract accounts receivable increase	-

**Focus Company Analysis** The excerpt below shows the Operating Activities section of Deckers's statement of cash flows. Sales growth during 2011 has resulted in an increase in Deckers's balance in receivables. This increase is subtracted in reconciling net income to cash flow from operating activities because revenues are higher than cash collected from customers for 2011. When receivables decrease, the amount of the reduction in receivables is added in reconciling net income to cash flow from operating activities because cash collected from customers is higher than revenues.

	2011
Cash flows from operating activities	
Net income	\$201,858
Adjustments to reconcile net income to net cash provided by operating activities:	
.....	...
Changes in operating assets and liabilities:	
Trade accounts receivable, net of provision for doubtful accounts	(76,712)
Inventories	(128,275)
.....	...
.....	...
Net cash provided by operating activities	\$ 30,091

\*For companies with receivables in foreign currency or business acquisitions/dispositions, the change reported on the cash flow statement will not equal the change in the accounts receivable reported on the balance sheet.

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When using the **percentage of sales method**, you directly compute the bad debt expense for the period by multiplying the amount of credit sales by the bad debt loss rate. With the **aging method**, you compute the estimated ending balance in the allowance and solve for the bad debt expense. This process involves multiplying the amount in each age category by the estimated percentage uncollectible to produce the estimated ending balance in the allowance for doubtful accounts. The difference between the estimated ending balance and the balance in the allowance before the adjustment becomes the bad debt expense for the year. Before you move on, try an example of the more difficult aging method computations based on Crocs's numbers reported in an earlier year.

### SELF-STUDY QUIZ

- In an earlier year, Deckers's competitor Crocs reported a beginning balance in the Allowance for Doubtful Accounts of \$5,262. It also wrote off bad debts amounting to \$2,551 during the year. At the end of the year, it computed total estimated uncollectible accounts using the aging method to be \$3,973 (all numbers in thousands of dollars). What amount did Crocs record as bad debt expense for the period? (**Solution approach:** Use the Allowance for Doubtful Accounts T-account or the following equation to solve for the missing value.)

Allowance for Doubtful Accounts (XA)	
Estimated ending balance in Allowance for Doubtful Accounts	_____
Less: Current balance in Allowance for Doubtful Accounts	_____
Bad Debt Expense for the year	=====

The accounts receivable turnover ratio measures the effectiveness of credit-granting and collection activities. Faster turnover means faster receipt of cash from your customers. To test whether you understand this concept, answer the following question:

- Indicate whether **granting later payment deadlines** (e.g., 60 days instead of 30 days) will most likely **increase** or **decrease** the accounts receivable turnover ratio. Explain.

After you have completed your answers, check them with the solutions at the bottom of the page.

---

Solutions to SELF-STUDY QUIZ

1.

Allowance for Doubtful Accounts (XA)			
		Beginning balance	5,262
Write-offs	2,551	Bad debt expense (solve)	<u>1,262</u>
		Ending balance	<u>3,973</u>
		Estimated ending balance in Allowance for Doubtful Accounts	3,973
		Less: Current balance in Allowance for Doubtful Accounts (\$5,262 – \$2,551)	<u>2,711</u>
		Bad Debt Expense for the year	<u>\$1,262</u>

2. Granting later payment deadlines will most likely decrease the accounts receivable turnover ratio because later collections from customers will increase the average accounts receivable balance (the denominator of the ratio), decreasing the ratio.
-

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## REPORTING AND SAFEGUARDING CASH

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### Cash and Cash Equivalents Defined

#### LEARNING OBJECTIVE 6-5

Report, control, and safeguard cash.

**CASH** is money or any instrument that banks will accept for deposit and immediate credit to a company's account, such as a check, money order, or bank draft.

**CASH EQUIVALENTS** are short-term investments with original maturities of three months or less that are readily convertible to cash and whose value is unlikely to change.

**Cash** is defined as money or any instrument that banks will accept for deposit and immediate credit to a company's account, such as a check, money order, or bank draft. **Cash equivalents** are investments with original maturities of three months or less that are readily convertible to cash and whose value is unlikely to change (that is, they are not sensitive to interest rate changes). Typical instruments included as cash equivalents are bank certificates of deposit and Treasury bills that the U.S. government issues to finance its activities.

Like most companies, Deckers combines all of its bank accounts and cash equivalents into one amount, Cash and Cash Equivalents, on the balance sheet. It also reports that the book values of cash equivalents on the balance sheet equal their fair market values—which we should expect given the nature of the instruments (investments whose value is unlikely to change).

### Cash Management

Many businesses receive a large amount of cash, checks, and credit card receipts from their customers each day. Anyone can spend cash, so management must develop procedures to safeguard the cash it uses in the business. Effective cash management involves more than protecting cash from theft, fraud, or loss through carelessness. Other cash management responsibilities include:

1. Accurate accounting so that reports of cash flows and balances may be prepared.
2. Controls to ensure that enough cash is available to meet (a) current operating needs, (b) maturing liabilities, and (c) unexpected emergencies.
3. Prevention of the accumulation of excess amounts of idle cash. Idle cash earns no revenue. Therefore, it is often invested in securities to earn a return until it is needed for operations.

## Internal Control of Cash

**INTERNAL CONTROLS** are the processes by which a company safeguards its assets and provides reasonable assurance regarding the reliability of the company's financial reporting, the effectiveness and efficiency of its operations, and its compliance with applicable laws and regulations.

The term **internal controls** refers to the process by which a company safeguards its assets and provides reasonable assurance regarding the reliability of the company's financial reporting, the effectiveness and efficiency of its operations, and its compliance with applicable laws and regulations. Internal control procedures should extend to all assets: cash, receivables, investments, plant and equipment, and so on. Controls that ensure the accuracy of the financial records are designed to prevent inadvertent errors and outright fraud. Because internal control increases the reliability of the financial statements, it is reviewed by the outside independent auditor.

Because cash is the asset most vulnerable to theft and fraud, a significant number of internal control procedures should focus on cash. You have already observed internal control procedures for cash, although you may not have known it at the time. At most movie theaters, one employee sells tickets and another employee collects them. Having one employee do both jobs would be less expensive, but that single employee could easily steal cash and admit a patron without issuing a ticket. If different employees perform the tasks, a successful theft requires the participation of both.



Effective internal control of cash should include the following:

1. Separation of duties.
  - a. Complete separation of the jobs of receiving cash and disbursing cash.
  - b. Complete separation of the procedures of accounting for cash receipts and cash disbursements.
  - c. Complete separation of the physical handling of cash and all phases of the accounting function.

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Prescribed policies and procedures.

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- a. Require that all cash receipts be deposited in a bank daily. Keep any cash on hand under strict control.
- b. Require separate approval of the purchases and the actual cash payments. Prenumbered checks should be used. Special care must be taken with payments by **electronic funds transfers** since they involve no controlled documents (checks).
- c. Assign the responsibilities for cash payment approval and check-signing or electronic funds transfer transmittal to different individuals.
- d. Require monthly reconciliation of bank accounts with the cash accounts on the company's books (discussed in detail in the next section).

## A QUESTION OF ETHICS



## Ethics and the Need for Internal Control

Some people are bothered by the recommendation that all well-run companies should have strong internal control procedures. These people believe that control procedures suggest that management does not trust the company's employees. Although the vast majority of employees are trustworthy, employee theft does cost businesses billions of dollars each year. Interviews with convicted felons indicate that in many cases they stole from their employers because they thought that it was easy and that no one cared (there were no internal control procedures).

Many companies have a formal code of ethics that requires high standards of behavior in dealing with customers, suppliers, fellow employees, and the company's assets. Although each employee is ultimately responsible for his or her own ethical behavior, internal control procedures can be thought of as important value statements from management.

## Reconciliation of the Cash Accounts and the Bank Statements

### Content of a Bank Statement

A **BANK STATEMENT** is a monthly report from a bank that shows deposits recorded, checks cleared, other debits and credits, and a running bank balance.

Proper use of the bank accounts can be an important internal cash control procedure. Each month, the bank provides the company (the depositor) with a **bank statement** that lists (1) each paper or electronic deposit recorded by the bank during the period, (2) each paper or electronic check cleared by the bank during the period, and (3) the balance in the company's account. The bank statement also

shows the bank charges or deductions (such as service charges) made directly to the company's account by the bank. A typical bank statement for ROW.COM, Inc., is shown in Exhibit 6.4.


Exhibit 6.4 lists four items that need explanation. Notice the \$500 and \$100 items listed in the Checks and Debits column and coded **EFT**.<sup>6</sup> This is the code for **electronic funds transfers**. ROW.COM pays its electricity and insurance bills using electronic checking. When it orders the electronic payments, it records these items on the company's books in the same manner as a paper check. So no additional entry is needed.

Notice that listed in the Checks and Debits column there is a deduction for \$18 coded **NSF**. This entry refers to a check for \$18 received from a customer and deposited by ROW.COM with its bank. The bank processed the check through banking channels to the customer's bank, but the account did not have sufficient funds to cover the check. The customer's bank therefore returned it to ROW.COM's bank, which then charged it back to ROW.COM's account. This type of check often is called an **NSF check** (not sufficient funds). The NSF check is now a receivable; consequently, ROW.COM must make an entry to debit Receivables and credit Cash for the \$18.

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## EXHIBIT 6.4

Example of a Bank Statement

		7TH & LAVACA AUSTIN, TEXAS 78788 PHONE: 512/476-8611							
Austin <small>NATIONAL ASSOCIATION</small>		<table border="1"> <tr> <th>ACCOUNT NUMBER</th> <th>STATEMENT DATE</th> <th>PAGE NO.</th> </tr> <tr> <td>877-95861</td> <td>6-30-14</td> <td>1</td> </tr> </table>		ACCOUNT NUMBER	STATEMENT DATE	PAGE NO.	877-95861	6-30-14	1
ACCOUNT NUMBER	STATEMENT DATE	PAGE NO.							
877-95861	6-30-14	1							
ROW.COM, Inc. 1000 Blank Road Austin, Texas 78703		<b>STATEMENT OF ACCOUNT</b> Please examine statement and checks promptly. If no error is reported within ten days, the account will be considered correct. Please report change of address. For questions or problems call TCB-Austin's Hotline—476-8100							
BALANCE LAST STATEMENT	DEPOSITS AND CREDITS		CHECKS AND DEBITS		BALANCE THIS STATEMENT				
7,762.40	No. 5	Total Amount 4,050.00	No. 14	Total Amount 3,490.20	8,322.20				
CHECKS AND DEBITS			DEPOSITS AND CREDITS		DAILY BALANCE				
Date	No.	Amount	Date	Amount	Date	Amount			
06-02	AUSTIN ENERGY	500.00 EFT	06-02	3,000.00	06-01-11	7,762.40			
06-03	120	55.00			06-02-11	10,262.40			
06-09	STATE FARM	100.00 EFT	06-09	500.00	06-03-11	10,207.40			
06-10	122	8.20			06-09-11	10,607.40			
06-11	124	2,150.00			06-10-11	10,599.20			
06-18	125	46.80	06-18	20.00 INT	06-11-11	8,449.20			
06-19	127	208.00			06-18-11	8,422.40			
06-24	128	82.70	06-24	230.00	06-19-11	8,214.40			
06-25		18.00 NSF			06-24-11	8,361.70			
06-25	129	144.40			06-25-11	8,343.70			
06-26	132	22.52	06-26	300.00	06-25-11	8,199.30			
06-27	130	96.50			06-26-11	8,476.78			
06-30	126	52.08			06-27-11	8,380.28			
06-30		6.00 SC			06-30-11	8,328.20			
					06-30-11	8,322.20			
Code: INT-Interest Earned NSF-Not Sufficient Funds SC-Service Charge EFT-Electronic Funds Transfer									
MEMBER F.D.I.C.			IMPORTANT: SEE REVERSE SIDE OF STATEMENT						

Notice the \$6 listed on June 30 in the Checks and Debits column and coded **SC**. This is the code for bank service charges. The bank statement included a memo by the bank explaining this service charge (which was not documented by a check). ROW.COM must make an entry to reflect this \$6 decrease in the bank balance as a debit to a relevant expense account, such as Bank Service Expense, and a credit to Cash.

Notice the \$20 listed on June 18 in the Deposits and Credits column and coded **INT** for interest earned. The bank pays interest on checking account balances, and it increased ROW.COM's account for interest earned during the period. ROW.COM must record the interest by making an entry to debit Cash and credit Interest Income for the \$20.

## Need for Reconciliation

A **BANK RECONCILIATION** is the process of verifying the accuracy of both the bank statement and the cash accounts of a business.

A **bank reconciliation** is the process of comparing (reconciling) the ending cash balance in the company's records and the ending cash balance reported by the bank on the monthly bank statement. A bank reconciliation should be completed at the end of each month. Usually, the ending cash

balance as shown on the bank statement does not agree with the ending cash balance shown by the related Cash ledger account on the books of the company. For example, the Cash ledger account of ROW.COM showed the following at the end of June (ROW.COM has only one checking account):

Cash (A)			
June 1 balance	7,753.40		
June deposits	5,830.00	June payments	4,543.40
Ending balance	9,040.00		

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The \$8,322.20 ending cash balance shown on the bank statement (Exhibit 6.4) differs from the \$9,040.00 ending balance of cash shown on the books of ROW.COM. Most of this difference exists because of timing differences in the recording of transactions:

**Page 296**

1. Some transactions affecting cash were recorded in the books of ROW.COM but were not shown on the bank statement.
2. Some transactions were shown on the bank statement but had not been recorded in the books of ROW.COM.

Some of the difference may also be caused by errors in recording transactions.

The most common causes of differences between the ending bank balance and the ending book balance of cash are as follows:

1. **Outstanding checks.** These are checks written by the company and recorded in the company's ledger as credits to the Cash account that have not cleared the bank (they are not shown on the bank statement as a deduction from the bank balance). The outstanding checks are identified by comparing the list of canceled checks on the bank statement with the record of checks (such as check stubs or a journal) maintained by the company.
2. **Deposits in transit.** These are deposits sent to the bank by the company and recorded in the company's ledger as debits to the Cash account. The bank has not recorded these deposits (they are not shown on the bank statement as an increase in the bank balance). Deposits in transit usually happen when deposits are made one or two days before the close of the period covered by the bank statement. Deposits in transit are determined by comparing the deposits listed on the bank statement with the company deposit records.
3. **Bank service charges.** These are expenses for bank services listed on the bank statement but not recorded on the company's books.
4. **NSF checks.** These are "bad checks" or "bounced checks" that have been deposited but must be deducted from the company's cash account and rerecorded as accounts receivable.
5. **Interest.** This is the interest paid by the bank to the company on its bank balance.
6. **Errors.** Both the bank and the company may make errors, especially when the volume of cash transactions is large.

## Bank Reconciliation Illustrated

The company should make a bank reconciliation immediately after receiving each bank statement. The general format for the bank reconciliation follows:

Ending cash balance per books	\$xxx	Ending cash balance per bank statement	\$xxx
+ Interest paid by bank	xx	+ Deposits in transit	xx
- NSF checks/Service charges	xx	- Outstanding checks	xx
± Company errors	xx	± Bank errors	xx
Ending correct cash balance	\$xxx	Ending correct cash balance	\$xxx

Exhibit 6.5 shows the bank reconciliation prepared by ROW.COM for the month of June to reconcile the ending bank balance (\$8,322.20) with the ending book balance (\$9,040.00). On the completed

reconciliation, the correct cash balance is \$9,045.00. This correct balance is the amount that should be shown in the Cash account after the reconciliation. Since ROW.COM has only one checking account and no cash on hand, it is also the correct amount of cash that should be reported on the balance sheet.<sup>7</sup>

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ROW.COM INC. Bank Reconciliation For the Month Ending June 30, 2014			
Company's Books		Bank Statement	
Ending cash balance per books	\$9,040.00	Ending cash balance per bank statement	\$ 8,322.20
Additions		Additions	
Interest paid by the bank	20.00	Deposit in transit	1,800.00
Error in recording payment	9.00		
	<u>9,069.00</u>		<u>10,122.20</u>
Deductions		Deductions	
NSF check of R. Smith	18.00	Outstanding checks	1,077.20
Bank service charges	6.00		
Ending correct cash balance	<u>\$9,045.00</u>	Ending correct cash balance	<u>\$ 9,045.00</u>

EXHIBIT 6-5

Bank Reconciliation Illustrated

ROW.COM followed these steps in preparing the bank reconciliation:

- 1. Identify the outstanding checks.** A comparison of the checks and electronic payments listed on the bank statement with the company's record of all checks drawn and electronic payments made showed the following checks were still outstanding (had not cleared the bank) at the end of June:

Check No.	Amount
121	\$ 145.00
123	815.00
131	117.20
Total	<u>\$1,077.20</u>

This total was entered on the reconciliation as a deduction from the bank account. These checks will be deducted by the bank when they clear the bank.

- 2. Identify the deposits in transit.** A comparison of the deposit slips on hand with those listed on the bank statement revealed that a deposit of \$1,800 made on June 30 was not listed on the bank statement. This amount was entered on the reconciliation as an addition to the bank account. It will be added by the bank when it records the deposit.
- 3. Record bank charges and credits:**
  - Interest received from the bank, \$20—entered on the bank reconciliation as an addition to the book balance; it already has been included in the bank balance.
  - NSF check of R. Smith, \$18—entered on the bank reconciliation as a deduction from the book balance; it has been deducted from the bank statement balance.
  - Bank service charges, \$6—entered on the bank reconciliation as a deduction from the book balance; it has been deducted from the bank balance.

- Determine the impact of errors.** At this point, ROW.COM found that the reconciliation did not balance by \$9. Upon checking the journal entries made during the month, the electronic payment on 6-09 for \$100 to pay an account payable was found. The payment was recorded in the company's accounts as \$109. Therefore, \$9 (i.e.,  $\$109 - \$100$ ) must be added to the book cash balance on the reconciliation; the bank cleared the electronic payment for the correct amount, \$100.

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Note that in Exhibit 6.5 the two sections of the bank reconciliation now agree at a correct cash balance of \$9,045.00.

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A bank reconciliation as shown in Exhibit 6.5 accomplishes two major objectives:

1. It checks the accuracy of the bank balance and the company cash records, which involves developing the correct cash balance. The correct cash balance (plus cash on hand, if any) is the amount of cash that is reported on the balance sheet.
2. It identifies any previously unrecorded transactions or changes that are necessary to cause the company's Cash account(s) to show the correct cash balance. Any transactions or changes on the **company's books side** of the bank reconciliation need journal entries. Therefore, the following journal entries based on the company's books side of the bank reconciliation (Exhibit 6.5) must be entered into the company's records:

### Accounts of ROW.COM

(a) Cash (+A) .....	20	
Interest income (+R, +SE) .....		20
To record interest by bank.		
(b) Accounts receivable (+A) .....	18	
Cash (-A) .....		18
To record NSF check.		
(c) Bank service expense (+E, -SE) .....	6	
Cash (-A) .....		6
To record service fees charged by bank.		
(d) Cash (+A) .....	9	
Accounts payable (+L) .....		9
To correct error made in recording a check payable to a creditor.		

Assets	=	Liabilities	+	Stockholders' Equity
Cash (+20, -18, -6, +9)	+5	Accounts payable	+9	Interest income (+R)      +20
Accounts receivable	+18			Bank service expense (+E)      -6

Notice again that all of the additions and deductions on the company's books side of the reconciliation need journal entries to update the Cash account. The additions and deductions on the bank statement side do not need journal entries because they will work out automatically when they clear the bank.



PAUSE FOR FEEDBACK

Cash is the most liquid of all assets, flowing continually into and out of a business. As a result, a number of critical control procedures, including the **reconciliation** of bank accounts, should be applied. Also,

management of cash may be critically important to decision makers who must have cash available to meet current needs yet must avoid excess amounts of idle cash that produce no revenue. To see if you understand the basics of a bank reconciliation, answer the following questions:

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## SELF-STUDY QUIZ

**Page 299**

Indicate which of the following items discovered while preparing a company's bank reconciliation will result in adjustment of the cash balance on the balance sheet.

1. Outstanding checks.
2. Deposits in transit.
3. Bank service charges.
4. NSF checks that were deposited.

*After you have completed your answers, check them with the solution at the bottom of the page.*

## EPILOGUE

As we noted at the beginning of the chapter, Deckers recognized that to turn growth into profits, it had to (1) continually refresh its product lines by introducing new technologies, new styles, and new product categories; (2) become a leaner and more nimble manufacturer, taking advantage of lower-cost, more flexible production locations; and (3) focus attention on inventory management and collections of accounts receivable since an uncollected account is of no value to the company. Each of these efforts is aimed at increasing net sales and/or decreasing cost of goods sold, thereby increasing gross profit. The first quarter of 2012 was a mixed bag for Deckers. Sales increased, but gross profit and net income declined compared to the first quarter of 2011. You can evaluate the further success of the company's strategy by going to the Web at [www.deckers.com](http://www.deckers.com) to check Deckers's latest annual and quarterly reports.

### DEMONSTRATION CASE A

(Complete the requirements before proceeding to the suggested solutions.) Wholesale Warehouse Stores sold \$950,000 in merchandise during 2014. Of this amount, \$400,000 was on credit with terms 2/10, n/30 (75 percent of these amounts were paid within the discount period), \$500,000 was paid with credit cards (there was a 3 percent credit card discount), and the rest was paid in cash. On December 31, 2014, the Accounts Receivable balance was \$80,000. The beginning balance in the Allowance for Doubtful Accounts was \$9,000 and \$6,000 of bad debts was written off during the year.

#### **Required:**

1. Compute net sales for 2014, assuming that sales and credit card discounts are treated as contra-revenues.
2. Assume that Wholesale uses the percentage of sales method for estimating bad debt expense and that it estimates that 2 percent of credit sales will produce bad debts. Record bad debt expense for 2014.
3. Assume instead that Wholesale uses the aging of accounts receivable method and that it estimates that \$10,000 worth of current accounts is uncollectible. Record bad debt expense for 2014.

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Solutions to SELF-STUDY QUIZ

3. Bank service charges are deducted from the company's account; thus, cash must be reduced and an expense must be recorded.
  4. NSF checks that were deposited were recorded on the books as increases in the cash account; thus, cash must be decreased and the related accounts receivable increased if payment is still expected.
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