

Visual Learning Maps

Introductory Financial Accounting



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VIRTUAL TEXT BOOK

Sales Discounts; Sales Returns & Allowances – 1 of 4

These two accounts are called **contra accounts** – because they are Debit balances, opposite to Sales which is a Credit balance.

WHAT ARE THEY?

Sales Discounts

Sales Discounts are pro actively managed by the business. A business gives discounts to customers, based on an operational policy for:

- Volume discounts – “Buy one pair of shoes; get the next pair at ½ price!”
- Cash discounts “Pay cash get 10% OFF!”
- Prompt payment – pay within 30 days and get 3% off

Businesses measure the total discounts to total sales to see if their target ratios are met. Questions management ask:

- Have sales increased with our discount policy?
- Should we change (increase / decrease) our discount policy?

Sales Returns & Allowances

Sales Returns & Allowances is a problem identification account. It is **reactively** managed by the business.

All businesses have the objective of having zero sales returns and allowances; but a policy will be established to determine the tolerance level as a percentage of sales.

Sales Returns are items purchased by customers, and then returned because they don't meet the specifications ordered by the customer; or they arrived late; or the customer received the wrong merchandise.

Sales Allowances are reductions in price given to the customer because the merchandise does not meet the specifications ordered by the customer, but the customer is willing to purchase the merchandise - if the vendor provides a price reduction. Examples: customer receives the wrong quantity; the shirts are the wrong color; the jeans are the wrong size.

Sales Discounts; Sales Returns & Allowances – 2 of 4

Sales Returns & Allowances...continued

The Importance of Managing These Accounts

The higher sales returns and allowances are as a percentage of sales; the bigger and more serious the problems are. It means that the merchandise sold is being returned by customers or allowances are being given more and more – there is something wrong with either the merchandise or the fulfillment system; or both.

Returns incur more cost in shipping; then more cost to determine what is wrong. Allowances reduce profit by the fact that a reduction in price was given to the customer; and also create additional investigative costs to determine why the allowance was given.

The higher the per unit sales price of merchandise is; the lower the tolerance percentage is. Companies selling commercial aircraft have a very low tolerance rate as compared to companies selling office supplies – still; the company selling the office supplies strives to reduce the percentage.

It is up to management to investigate, define and solve the problems before the customer base is eroded. Questions management ask:

- Why are customers returning our merchandise – is it us or our suppliers?
- Why are deliveries late – is it us or our delivery contractor?
- What precisely is the nature of the allowances we are giving – is the merchandise not meeting specifications?

SALES RETURNS AND ALLOWANCES NOT ONLY CREATE MORE COST – THEY IRRITATE CUSTOMERS.

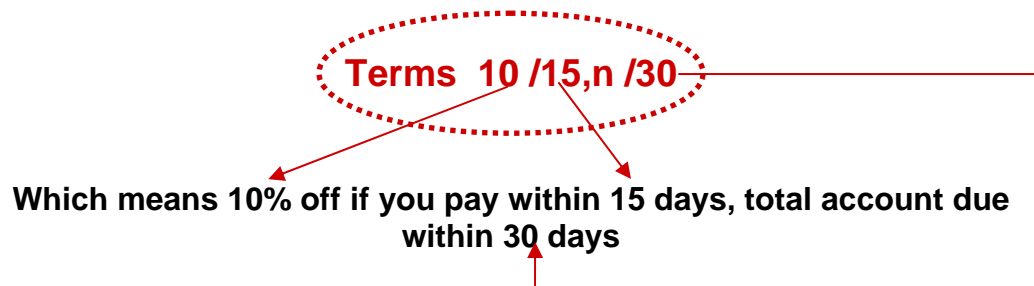
You cannot find brand loyalty on a balance sheet, but it is a business factor constantly on management's mind.

Sales Discounts; Sales Returns & Allowances – 3 of 4

Accounting Entries Sales Discounts

Discounts on Credit Sales

Discounts on credit sales relate to “prompt payment.” For example – a business may offer a 10% discount if the customer pays the account within 15 days (**the Discount Period**); the account is due after 30 days. These are called payment TERMS and always look like this on the invoice.



Example – Event 1: On June 1 product is sold to a customer in the amount of \$100 on credit at the above terms.

Step 1 is to record the sale:

	<u>Debit</u>	<u>Credit</u>
Accounts receivable	100	
Sales		100

No entry to Discounts - because we don't know yet if the customer will pay within the 15 days.

Event 2: The customer pays on June 15.

Step 2 is to record receiving payment from the customer:

	<u>Debit</u>	<u>Credit</u>
Cash	90	
Sales discounts	10	
Accounts Receivable		100

The customer paid on time, therefore gets the discount.

If the customer pays after June 16, the payment is required to be \$100. Debit cash and credit accounts receivable when the \$100 payment is received.

Sales Discounts; Sales Returns & Allowances – 4 of 4

Accounting Entries – Sales Returns & Allowances

When merchandise that was sold is returned by the customer or an allowance is given to the customer, the business records the event.

Example - Event 1: Customer buys product for \$900 on Monday the 15th;

Record the Sale

	<u>Debit</u>	<u>Credit</u>
Cash	900	
Accounts receivable		900

Event 2: Customer returns \$100 of product (or a \$100 allowance is given to the customer) on Tuesday the 23rd

Record the Return/ Allowance and the issuance of a credit memo to the customer

	<u>Debit</u>	<u>Credit</u>
Sales Returns & Allowances	100	
Accounts receivable		100

Detailed Management Focus & Why

Management may want to keep track of Returns and Allowances in separate accounts and in sub accounts itemizing specific detail as to why returns were made and allowances to provide an information data base with data elements of:

- Who
- Late delivery
- Wrong specifications
- Defective products by product
- Wrong quantity
- Amounts