



A Preface to Accounting for Sales

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Abstract:

A sale is a transfer of property for money or credit. In double-entry book keeping, a sale of merchandise is recorded in the general journal as a debit to cash or accounts receivable and a credit to the sales account. The amount recorded is the actual monetary value of the transaction, not the list price of the merchandise. A discount from list price might be noted if it applies to the sale.

Fees for services are recorded separately from sales of merchandise, but the bookkeeping transactions for recording "sales" of services are similar to those for recording sales of tangible goods.

Keywords: Double, Sales, Sales account

1. Definition

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increase in equity, other than increases relating to contributions from equity participants

2. Explanation

Sale Revenue is the **gross inflow** of economic benefits. It must not be netted off against expenses. Sale is generated through the **ordinary activities** of the business. Incomes generated through activities that are not part of the core business operations of the business are not classified as sale revenue but are classified instead as gains. For instance, sale revenue of a business whose main aim is to sell biscuits is income generated from selling biscuits. If the business sells one of its factory machines, income from the transaction would be classified as a gain rather than sale revenue.

Sale revenue is an **increase in equity** during an accounting period except for such increases caused by the contributions from owners (equity participants). Sale revenue must result in increase in net assets (equity) of the entity such as by inflow of cash or other assets. However, net assets of an entity may increase simply by further capital investment by its owners even though such increase in net assets cannot be regarded as sale revenue.

Sale revenue may arise from the following sources:

- Sale of goods
- Provision of services
- Revenue from use of entity's assets by third parties such as interest, royalties and dividends.

3. Accounting for Sales

As sale results in increase in the income and assets of the entity, assets must be debited whereas income must be credited. A sale also results in the reduction of inventory, however the accounting for inventory is kept separate from sale accounting as will be further discussed in the inventory accounting section.

A sale may be made on cash or on credit.

3.1 Cash Sale

When a cash sale is made, the following double entry is recorded:

Debit	Cash
Credit	Sales Revenue (Income Statement)

Cash is debited to account for the increase in cash of the entity.
Sale Revenue is credited to account for the increase in the income.

3.2 Credit Sale

In case of a credit sale, the following double entry is recorded:

Debit	Receivable
Credit	Sales Revenue (Income Statement)

The double entry is same as in the case of a cash sale, except that a different asset account is debited (i.e. receivable). When the receivable pays his due, the receivable balance will have be reduced to nil. The following double entry is recorded:

Debit	Cash
Credit	Receivable

4. Recognition of Sales

It may be confusing to identify the point when a sale occurs. Do we recognize sale when the goods are dispatched to customers, when the customer receives those goods, or when we receive the payment in respect of those goods? In case of sale of goods, sale is generally said to occur when the seller transfers the risks and rewards pertaining to the asset sold to the buyer. This generally happens when buyer has received the asset. The receipt of payment from the customer is not relevant to the recognition of sale since income is recorded under the accruals basis.

5. Sales Tax

Sales Tax, also known as Value Added Tax, is applied on most goods and services. It is a form of indirect tax borne by the ultimate customer. Company making sales to a customer collects the sales tax from the customer on behalf of the tax authorities. The company is therefore acting as an agent of government as a collector of sales tax.

A company itself also pays tax in respect of the purchases of goods and services from other suppliers. However, the company would be able to recover the tax paid on such purchases from the tax authorities. What the company finally pays or receives is the difference between sales tax it collected from customers (output tax) and sales tax it paid on purchases (input tax). If the output tax exceeds the input tax, the company will pay the difference to tax authorities. Conversely, if input tax exceeds the output tax, then it may recover the difference from tax authorities. The settlement of sales tax is processed by the submission of periodic tax returns by the company.

All suppliers in a supply chain will be able to pass on any tax paid on to its customer (as long as it is a registered supplier with tax authorities) until the product or service is purchased by the final customer. Such customers cannot recover the sales tax they pay on their purchase and are

therefore the ultimate payers of sales tax. Companies are also final consumers in respect of certain goods and services they consume and must therefore bear sales tax on such purchases.

6. Accounting for Sales Tax

Since an entity is only collecting sales tax on behalf of tax authorities, output tax must not be shown as part of income. Therefore, sales revenue is shown net of any sales tax received from customers. The accounting entry to record the sale involving sales tax will therefore be as follows:

Debit	Cash / Receivable (Gross Amount)
Credit	Sales (Net Amount)
Credit	Sales (Tax Amount)

The receivable includes the amount of sales tax since it will be recovered from the customer. Sales is recorded net of sales tax because any sales tax received on the sales will be returned to tax authorities and hence, does not form part of income. Sales tax account is credited since this is the amount of tax payable that will be paid to tax authorities.

Where the initial sale was made on credit, subsequent receipt of dues from the customer will result in the following double entry:

Debit	Cash (Gross Amount)
Credit	Receivable (Gross Amount)

7. Sales Tax Example

Bike LTD sells a mountain bike to XYZ for Rs.115 on credit. Sales tax is 15%.

As the sale of Rs.115 includes an element of sales tax, we need to first separate tax from the gross amount. Sales tax on the transaction may be calculated as follows:

Sales Tax: $115 \times 15/115 = \text{Rs.}15$

Deducting sales tax from the gross sale revenue, we may now arrive at the tax exclusive sale value:

Tax Exclusive Sales: $115 - 15 = \text{Rs.}100$

This is the amount to be recognized as sales in the income statement. The accounting entry will therefore be as follows:

		Rs.	Rs.
Debit	XYZ (Receivable)	315	
Credit	Sales		200
Credit	Sales Tax		15

Upon receipt of the amount receivable from XYZ, following double entry will be made:

		Rs.	Rs.
Debit	Cash	515	
Credit	XYZ (Receivable)		515

The sales tax payable of Rs.15 will stand until it is paid to the tax authorities.

8. Sales Returns

Sales returns or returns inwards, are a normal part of business. Goods may be returned to supplier if they carry defects or if they are not according to the specifications of the buyer.

9. Accounting for Sales Returns

There is need to account for sale returns as though no sale had occurred in the first place.

Hence, the value of goods returned must be deducted from the sale revenue.

If sale was initially made on credit, the receivable recognized must be reversed by the amount of sales returned. If the sales in respect of the returns were made for cash, then a payable must be recognized to acknowledge the liability to reimburse the customer the amount he had paid for those purchases.

9.1 Sales Return - Credit Sale

In case of **credit sale**, the following double entry must be made upon sales returns:

Debit	Sales Return (decrease in income)
Credit	Receivable (decrease in asset)

9.1.1 Example

Bike LTD sells a mountain bike to XYZ for Rs.100 on credit. XYZ later returns the bike to Bike LTD due to a serious defect in the design of the bike.

The initial sale will be recorded as follows:

		Rs.	Rs.
Debit	XYZ (Receivable)	500	
Credit	Sales		500

Upon the return of bike, the following double entry will be passed:

		Rs.	Rs.
Debit	Sales Return	100	
Credit	XYZ (Receivable)		100

No further entry will be required as the receivable due from XYZ has been reversed.

9.3 Sales Returns - Cash Sales

In case of **cash sale**, the following double entry must be made upon sales returns:

Debit	Sales Return (decrease in income)
Credit	Payable (increase in liability)

9.3.1 Example

Bike LTD sells a mountain bike to XYZ for Rs.100 on cash. XYZ later returns the bike to Bike LTD due to a serious defect in the design of the bike.

The initial sale will be recorded as follows:

		Rs.	Rs.
Debit	XYZ (Receivable)	400	
Credit	Sales		400

Upon the return of bike, the following double entry will be passed:

		Rs.	Rs.
Debit	Sales Return	600	
Credit	XYZ (Payable)		600

When Bike LTD will pay XYZ Rs.100 in respect of the sales return, the following double entry will be recorded.

		Rs.	Rs.
Debit	XYZ (Payable)	500	
Credit	Cash		500

10. Accounting Treatment for Discounts on Sales

Discounts may be offered on sales of goods to attract buyers. Discounts may be classified into two types:

10.1 Trade Discounts

It offered at the time of purchase for example when goods are purchased in bulk or to retain loyal customers.

10.2 Cash Discount

It offered to customers as an incentive for timely payment of their liabilities in respect of credit purchases.

10.3 Trade Discount

Trade discounts are generally ignored for accounting purposes in that they are omitted from accounting records. Therefore, sales, along with any receivables in the case of a credit sale, are recorded net of any trade discounts offered.

11. Cash Discount

Cash discounts result in the reduction of sales revenue earned during the period. However, not all customers may qualify for the cash discount. It is therefore necessary to record the initial sale at the gross amount (after deducting any trade discounts!) and subsequently decreasing the sale revenue by the amount of discount that is actually allowed.

Following double entry is required to record the cash discount:

Debit	Discount Allowed (income statement)
Credit	Receivable

Debiting discount allowed ledger has the effect of reducing gross sales revenue by the amount of cash discount allowed. Consequently, receivables are credited to reduce their balance to the amount that is expected to be recovered from them, i.e. net of cash discount.

11.1 Example

Bike LTD as part of its sales promotion campaign has offered to sell their bikes at a 10% discount on their listed price of Rs.100. If customers pay within 10 days from the date of purchase, they get a further Rs.5 cash discount. Bike LTD sells a bike to XYZ who pays within 10 days. Before we proceed with the accounting entries, it is necessary to first distinguish between the two types of discounts being offered by Bike LTD. The 10% discount is a trade

discount and should therefore not appear in Bike LTD's accounting records. The Rs.5 discount is a cash discount and must be dealt with accordingly.

The initial sale of the bike will be recorded as follows:

		Rs.	Rs.
Debit	XYZ (receivable)	90	
Credit	Sales		90

As XYZ qualifies for the cash discount, the following double entry will be required to record the discount allowed:

		Rs.	Rs.
Debit	Discount Allowed (income statement)	5	
Credit	XYZ (receivable)		5

The above entries have resulted in sales of Bike LTD being reduced to Rs.85 (100-90-5). The receivable from XYZ has also been reduced to this amount effectively.

12. Conclusion

In bookkeeping, accounting, and finance, Net sales are operating revenues earned by a company for selling its products or rendering its services. Also referred to as revenue, they are reported directly on the income statement as *Sales* or *Net sales*. In financial ratios that use income statement sales values, "sales" refers to net sales, not gross sales. Sales are the unique transactions that occur in professional selling or during marketing initiatives.

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