Scores BUS312A/612A First Exam

- n = 97
- Perfect 102.5
- High 94
- Low 47
- Mean 74.0
- Median 76.0
- Std Dev 10
BUS312A/612A
Financial Reporting I


Receivables
Chapter 7
Chapter 7- You should be able to:

– Identify elements of cash

– Identify the types of receivables

– Explain accounting for discounts

– Account for bad debts using both a balance sheet approach and an income statement approach

– Account for dispositions of accounts receivable, including collection, pledging as collateral, and factoring (selling)

– Extract and interpret information on receivables from the financial statements
A **current asset** is defined as any asset that is intended to be converted into cash within one year or the company’s **operating cycle**, whichever is longer. i.e., Cash, Marketable Securities, Accounts Receivable, Inventory, Supplies, Prepaids
Proper Cash Management

- Restrictions placed on a company’s access to its cash are typically imposed by creditors to help ensure future interest and principal payments, i.e., loan or debt covenants.
- Compensating balances are sometimes required
- Control Record over cash, i.e., bank reconciliation
- Physical Control over cash, i.e., petty cash, signatures on checks
Cash & Cash Equivalents – Exercise 7-2

1. Checking account balance $925,000
   Certificate of Deposit $1,400,000
   Cash Advance to subsidiary $980,000
   Utility deposit paid to gas company $180
   \[ \frac{925,000}{- \text{Cash}} - \frac{1,400,000}{- \text{Temporary Inv+}} - \frac{980,000}{- \text{Other Rec}} - \frac{180}{- \text{Other Rec}} \]

2. Checking account balance $600,000
   Overdraft in account at same bank $17,000
   Cash held in bond sinking fund $200,000
   Petty cash fund $300
   Coins and currency on hand $1,350
   \[ \frac{600,000}{- \text{Cash}} - \frac{17,000}{- \text{Cash}} - \frac{200,000}{- \text{Noncurrent Inv+}} - \frac{300}{- \text{Cash}} - \frac{1,350}{- \text{Cash}} \]
   \[ 600,000 - 17,000 + 300 + 1,350 = 584,650 \]

3. Checking account balance $590,000
   Postdated check from customer $11,000
   Cash restricted from compensating balance $100,000
   Certified check from customer $9,800
   Postage stamps $620
   \[ \frac{590,000}{- \text{Cash}} - \frac{11,000}{- \text{AR}} - \frac{100,000}{- \text{Prepaid}} - \frac{9,800}{- \text{Cash}} - \frac{620}{- \text{Footnote}} \]
Cash & Cash Equivalents – Exercise 7-2

4. Checking account balance $42,000
Money market (with checking privileges) $48,000
NSF check from customer $800

\[ 37,000 \text{ Cash} \]
\[ 85,000 \text{ AR} \]

5. Checking account balance $700,000
Cash restricted for plant expansion $500,000
Short-term treasury bills $180,000
Cash advance from customer $900
Cash advance to company executive $7,000
\[ \text{(payable on demand)} \]
Refundable deposit to government $26,000
\[ \text{(to guarantee performance on contract)} \]

\[ 700,900 \text{ Cash & Cash Equivalents} \]
\[ 26,000 \text{ Other Rec} \]
\[ 7,000 \text{ Other Rec} \]
\[ 500,000 \text{ Non Current} \]
\[ 180,000 \text{ Temporary Inv} \]
<table>
<thead>
<tr>
<th>Item</th>
<th>Classification</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Cash</td>
<td>If unrestricted, report as cash. If restricted, identify and classify as current and noncurrent assets.</td>
</tr>
<tr>
<td>Petty cash and change funds</td>
<td>Cash</td>
<td>Report as cash.</td>
</tr>
<tr>
<td>Short-term paper</td>
<td>Cash equivalents</td>
<td>Investments with maturity of less than three months, often combined with cash.</td>
</tr>
<tr>
<td>Short-term paper</td>
<td>Temporary investments</td>
<td>Investments with maturity of 3 to 12 months.</td>
</tr>
<tr>
<td>Postdated checks and IOU’s</td>
<td>Receivables</td>
<td>Assumed to be collectible.</td>
</tr>
<tr>
<td>Travel advances</td>
<td>Receivables</td>
<td>Assumed to be collected from employees or deducted from their salaries.</td>
</tr>
<tr>
<td>Postage on hand (as stamps or in postage meters)</td>
<td>Prepaid expenses</td>
<td>May also be classified as office supplies inventory.</td>
</tr>
<tr>
<td>Bank overdrafts</td>
<td>Current liability</td>
<td>If right of offset exists, reduce cash.</td>
</tr>
<tr>
<td>Compensating balances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Legally restricted</td>
<td>Cash separately classified as a deposit maintained as compensating balance</td>
<td>Classify as current or noncurrent in the balance sheet.</td>
</tr>
<tr>
<td>2. Arrangement without legal restriction</td>
<td>Cash with note disclosure</td>
<td>Disclose separately in notes details of the arrangement.</td>
</tr>
</tbody>
</table>
Accounts Receivable

- Accounts receivable arise from selling goods or services to customers on account.
- Recorded at face amount to be collected.
- However, we must also reflect the fact that a portion of A/R may not be collected.
  - Net Realizable Value
- Reasons for lack of collection:
  1. sales discounts (cash discounts)
  2. sales returns
  3. sales allowances
  4. uncollectible A/R (bad debts, doubtful accounts)
Cash/Sales Discounts

- Offered to encourage early payment
- Examples
  - 2/10, net 30
  - 2/10, EOM
- Accounting approaches
  - Gross Method - records discounts when taken by customers
  - Net Method - records discounts not taken by customers

3/5, 2/15, n/30
Accounts Receivable

**Exercise 7-4:** During first year of business

- Collections from customers: $198,000
- Merchandise purchased: 320,000
- Ending merchandise inventory: 90,000
- Goods are marked to sell at 40% above cost
- Reported Accounts Receivable balance: 82,000

Did you pay for her new car? Yes

<table>
<thead>
<tr>
<th>Beg Sales</th>
<th>Credit</th>
<th>Beg C/O</th>
<th>Beg Inv</th>
<th>C/Oss</th>
<th>Inv</th>
<th>Customers pay</th>
<th>End Inv</th>
</tr>
</thead>
<tbody>
<tr>
<td>320,000</td>
<td>322,000</td>
<td>198,000</td>
<td>42,000</td>
<td></td>
<td></td>
<td>198,000</td>
<td>90,000</td>
</tr>
</tbody>
</table>
Accounts Receivable

- Valuation
  - Current Cash Equivalent for Measuring Liquidity
  - Net Realizable Value for Balance Sheet Presentation
Direct Write-off Method for AR

- Used primarily in Cash Basis Accounting
- Income tax filings
- No adjusting journal entry
- Write-off entry
- Recovery entry

1. Dr Bad Debt Exp xx
   Cr AIR-Name xx

2. Dr AIR-Name xx
   Cr Bad Debt Exp xx

3. Dr Cash xx
   Cr AIR-Name xx
Account Anatomy - Direct Writeoff

\[ \text{Actual} \quad \text{Estimate} \quad \text{No} \]

\[ \text{Bad Debt} \quad \text{Expense} \quad \text{Writeoff} \quad \text{Recovery} \]

\[ \text{YF} \quad \text{Closed} \]

\[ \text{Begin} \quad \text{Ar} \quad \text{End} \quad \text{Credit Sales} \quad \text{Collections} \quad \text{Writeoff} \]

[Diagram of account anatomy with arrows and labels]
Uncollectibles/Doubtful Accounts/Bad Debts

- Allowance method – IFRS and US GAAP

- Two approaches
  - % of Sales (determines expense)
  - or
  - % of Outstanding Receivables (determines balance in allowance account)
Uncollectibles Terminology

- Specific write off (when the company decides the debt won’t be paid—transaction)

- Provision for doubtful accounts or bad debt expense or… (adjustment)

- Allowance for doubtful or uncollectible accounts (amount of outstanding A/R balance expected to go bad but you don’t yet know who)
Allowance for Doubtful Accts. (T-account)

<table>
<thead>
<tr>
<th>Allowance for Doubtful Accts.</th>
<th>Bad Debts Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Write-off of accounts</strong></td>
<td><strong>AJE estimates bad debt expense</strong></td>
</tr>
<tr>
<td><strong>receivable</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Beginning Balance</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Recover write-off</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Ending Balance</strong></td>
<td></td>
</tr>
</tbody>
</table>

The AJE to record the estimate of uncollectibles. **Aging** calculates the expense amount necessary to achieve the “desired ending balance” in the allowance account. OR **% of Sales** is the Expense and then compute **EB** in Allowance account.

Accounts Receivable

<table>
<thead>
<tr>
<th>Beginning Bal. Credit sales</th>
<th>Customer pays AR Write-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recover write off Ending Bal.</td>
<td></td>
</tr>
</tbody>
</table>
Accounting for Bad Debts

Specific Write-off or Allowance Method?

Allowance Method: Estimate Bad Debts Expense each year and reduce Accounts Receivable using a contra account. Move the reduction from the contra to the Accounts Receivable account when a specific account is known to be uncollectible.

Entry:

Bad Debts Exp. xx
Accounts Rec. xx

Which method is used to estimate bad debts expense?

% of Sales Method
Recognize Bad Debts Expense for the amount of bad debts expected to result from the current year’s sales, using a percent of sales.

% of Accounts Receivable Method
Recognize Bad Debts Expense for the amount that will cause the contra account balance to equal the % of year-end accounts receivable not expected to be collected.

Aging of Accounts Receivable Method
Same as the % of Accounts Receivable Method except it uses different percentages for accounts based on their age -- higher % for older accounts.

Journal Entries for Allowance Method on next slide
Journal Entries for Allowance method of Accounting for Bad Debts

To record bad debts expense:

Bad Debts Expense
Allowance for Uncollectible Accounts

To write off bad accounts:

Allowance for Uncollectible Accounts
Accounts Receivable
Recovery of Bad Debts

If a receivable is collected after it has been written off, it should be restored by making the reverse of the entry that was made to write it off:

**Allowance Method**

Accounts Receivable xxx

Allowance for Bad Debts xxx

**Direct/Specific Write-Off Method**

Accounts Receivable xxx

Bad Debts Expense xxx

The collection of the receivable is then recorded in the usual fashion:

Cash xxx

Accounts Receivable xxx
Year-end Entries: Bad Debts

- During 2015, Omega Company had net sales of $11,400,000. Most of the sales were on credit. At the end of 2015, the balance of Accounts Receivable was $1,400,000, and Allowance for Uncollectible Accounts had a debit balance of $48,000.

- Omega Company's management uses two methods of estimating uncollectible accounts expense: the percentage of net sales method and the accounts receivable aging method. The percentage of uncollectible sales is 1.5 percent of net sales, and based on an aging of accounts receivable, the end-of-year uncollectible accounts total $140,000.

1. Prepare the end-of-year adjusting entry to record the uncollectible accounts expense under each method.

2. What will the balance of Allowance for Uncollectible Accounts be after each adjustment?

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**Percentage of Sales Method**

- **Dr Bad Debt Exp:** $171,000
- **Cr Allow:** $171,000

1.5% of $11,400,000

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**Aging Method**

- **Dr Bad Debt Exp:** $188,000
- **Cr Allow:** $188,000

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**Allowance after Adjustments**

- **Percentage of Sales Method:** $123,000
- **Aging Method:** $140,000
Write-off of Accounts Receivable

Colby Company, which uses the allowance method, has Accounts Receivable of $65,000 and an allowance for uncollectible accounts of $6,400 (credit). The company sold merchandise to Irma Hegerman for $7,200 and later received $2,400 from Hegerman. The rest of the amount due from Hegerman had to be written off as uncollectible.

Using T accounts, show the beginning balances and the effects of the Hegerman transactions on Accounts Receivable and Allowance for Uncollectible Accounts.

What is the amount of net accounts receivable before and after the write-off?

Before NRV: \[ 69,800 - 6,400 = 63,400 \]

After: \[ 65,000 - 1,600 = 63,400 \]
E7-10 (Bad Debt Reporting) The chief accountant for Dickinson Corporation provides you with the following list of accounts receivable written off in the current year.

<table>
<thead>
<tr>
<th>Date</th>
<th>Customer</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31</td>
<td>E.L Masters Company</td>
<td>$7,800</td>
</tr>
<tr>
<td>June 30</td>
<td>Hocking Associates</td>
<td>$9,700</td>
</tr>
<tr>
<td>September 30</td>
<td>Amy Lowell’s Dress Shop</td>
<td>$7,000</td>
</tr>
<tr>
<td>December 31</td>
<td>R. Frost, Inc.</td>
<td>$9,830</td>
</tr>
</tbody>
</table>

Dickinson debits Bad Debt Expense as accounts are written off. The chief accountant maintains that this procedure is appropriate for financial statement purposes because the Internal Revenue Service will not accept other methods for recognizing bad debts.

All of Dickinson’s sales are on a 30-day credit basis. Sales for the current year total $2,200,000, and bad debt losses approximate 2% of sales.

(a) Do you agree with Dickinson’s policy for recognizing bad debt expense? Why?

No, Matching, Net Realizable Value

(b) By what amount would Net Income differ if bad debt expense was computed using the % of sales approach?

\[ NI = \frac{44,000}{31,330} = 1,412 \]