

Financial Reporting: Asset Valuation and Income Measurement

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OBJECTIVES

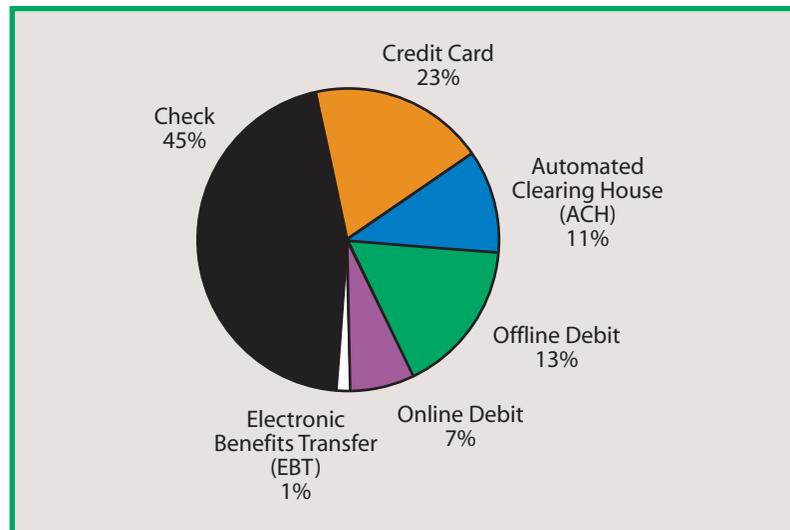
After reading this chapter, you will be able to:

- 1 Identify items of cash (and cash equivalents).
- 2 Understand the importance of cash management.
- 3 Discuss revenue recognition when the right of return exists.
- 4 Understand the credit policies and internal control related to accounts receivable.
- 5 Explain the gross and net methods to account for cash discounts.
- 6 Estimate and record bad debts using a percentage of sales.
- 7 Estimate and record bad debts using an aging analysis.
- 8 Explain pledging, assignment, and factoring of accounts receivable.
- 9 Account for short-term notes receivable.
- 10 Understand a petty cash fund (Appendix).
- 11 Prepare a bank reconciliation (Appendix).

Cash and Receivables

Show Me the Money!

Cash is the lifeblood for companies and infusions are coming more frequently from nontraditional sources. According to the 2004 Federal Reserve Payments Study, Americans are for the first time using electronic “money” such as debit and credit cards more frequently than checks to pay their bills.



Hastening the decline in the use of checks is a process known as accounts receivable conversion (ARC). In ARC, when paper checks arrive at a bank lockbox, they are converted into automated clearing house debits and the check itself is then

Credit: MICHAEL NAGLE/Bloomberg News/Landov

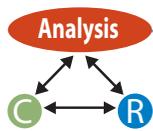


destroyed. For banks, the savings are obvious—ARC payments are about one-third cheaper than handling checks and float time (the time it takes for a check to clear the bank) is cut in half. Additionally, the Check Clearing for the 21st Century Act is a recently enacted law that gives legal status to substitute checks. Termed Check 21, this act allows merchants to scan checks and transmit the digital images to the bank instead of sending the actual check. Whether it is ARC or Check 21, one thing is clear—making payments will never be the same again.

FOR FURTHER INVESTIGATION

For a discussion of ARC or Check 21, consult the Business & Company Resource Center (BCRC):

- Tear Out a Check, Then Watch it Vanish. Jeffrey Selinger, *The New York Times*, 0362-4331, October 9, 2003, pG6 col. 04.
- Why Check 21 Could Erase ARC's Gains. Will Wade, *American Banker*, 0002-7561, November 5, 2003, v168, i213, p1.



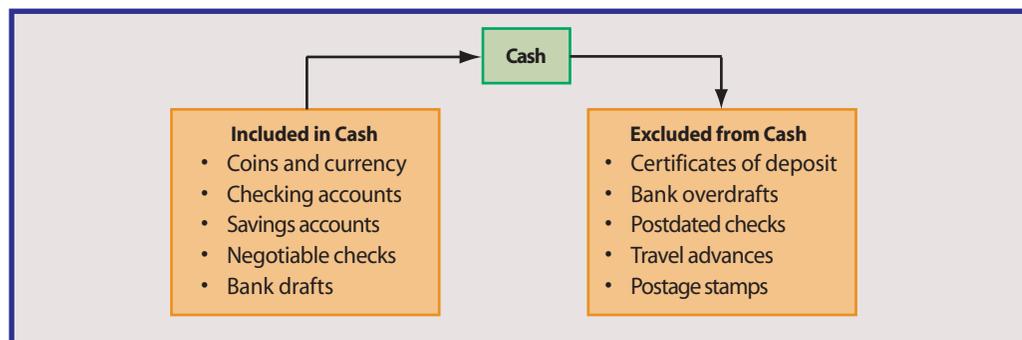
Financial statement users focus on a variety of information in making credit and investment decisions. Investors, long-term creditors, and short-term creditors are interested in a company's **financial flexibility**, the ability to use its financial resources to adapt to change. One part of a company's financial flexibility that external users are concerned about is liquidity. **Liquidity** is the availability of a company's liquid assets (cash or assets that may be quickly converted into cash) to pay its bills. The most common liquid assets are cash, temporary investments, accounts receivable, and notes receivable. In this chapter we discuss the measurement and valuation procedures for cash, accounts receivable, and notes receivable. Because the accounting principles for temporary investments are similar to those for most long-term investments, we do not discuss temporary investments until Chapter 15.

CASH

Cash is the resource on hand to meet planned payments and emergency situations. **The amount a company reports as cash in the current assets section on its balance sheet must be available to pay current obligations.** There must not be any contractual restrictions that prevent the company from using this money to pay its current debts. For example, some companies create sinking funds into which they deposit cash over an extended period. At the end of the period, the cash (plus accumulated interest) is to be used for a specific purpose (e.g., to retire long-term bonds). Amounts in sinking funds are not classified as cash on the balance sheet; a company normally reports these amounts in the long-term investments category.

Cash classified as a current asset includes coins, currency, unrestricted funds on deposit with a bank (either checking accounts or savings accounts¹), **negotiable checks, and bank drafts.** On the other hand, some items may be confused with cash but normally are listed under other balance sheet captions. Among these items are certificates of deposit, bank overdrafts, postdated checks, travel advances, and postage stamps. *Certificates of deposit (CDs)* are short-term investments issued by banks that allow a company to invest idle cash for short periods of time. CDs normally are classified as temporary investments. *Bank overdrafts* are overdrawn checking accounts. They are reported as current liabilities and should *not* be offset against positive balances in other bank accounts. *Postdated checks* from customers are checks dated in the future so they become payable on a date later than the issue date. Postdated checks are included as receivables until the date they become negotiable. *Travel advances* are funds or checks given to company employees to cover out-of-pocket expenses while traveling on company business. Since travel advances are satisfied when the employee submits receipts for business expenses, they are classified as prepaid items. *Postage stamps* on hand are classified as prepaid items because they will be used rather than exchanged for cash. Below is a diagram that summarizes what is, and what is not, included in cash.

1 Identify items of cash (and cash equivalents).



1. Although some banks place restrictions on the withdrawal of funds from savings accounts, they generally are included as a component of cash.

In summary, to be classified under the current asset—Cash—caption on a company's balance sheet, amounts must be available immediately to pay its bills and may not be bound by any contractual or legal restrictions. Items that do not meet these criteria are reported elsewhere within the assets (or liabilities) section on the balance sheet.

Cash and Cash Equivalents

Some companies use the title Cash on their balance sheets. An increasing number (approximately 88%)², however, use a title such as *Cash and Cash Equivalents*. In addition to cash, these companies include in this category items that are considered to be “cash equivalents” because of their liquidity and low risk. **Cash equivalents** are short-term, highly liquid investments that are readily convertible into known amounts of cash and so near their maturity that there is little risk of changes in value because of changes in interest rates. Generally, only investments with maturity dates of three months or less from the date acquired by the holder are cash equivalents.³ Securities such as commercial paper, treasury bills, and money market funds are examples of cash equivalents. For instance, in its December 31, 2004 balance sheet, **Eastman Kodak Company** reported cash and cash equivalents as a current asset. Then it included a note describing its cash equivalents in the notes to its financial statements, as we show in Real Report 7-1.

Real Report 7-1 Cash and Cash Equivalents

EASTMAN KODAK COMPANY AND SUBSIDIARY COMPANIES		
CONSOLIDATED STATEMENT OF FINANCIAL POSITION (in part)		
(in millions, except share and per share data)	At December 31	
	2004	2003
ASSETS		
Current Assets		
Cash and cash equivalents	\$1,255	\$1,250
NOTES TO FINANCIAL STATEMENTS		
<i>NOTE 1: Significant Accounting Policies (in part)</i>		
Cash Equivalents All highly liquid investments with a remaining maturity of three months or less at date of purchase are considered to be cash equivalents.		



Questions:

1. Why does Eastman Kodak combine cash and cash equivalents into one amount on the balance sheet?

A clear understanding of what items a company includes in Cash and Cash Equivalents is important because when preparing its statement of cash flows, it must reconcile its cash inflows and outflows to the change in cash and cash equivalents. In this chapter for simplicity we focus our discussion on Cash.

Cash Management

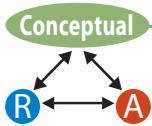
Efficient cash management is very important to every company. Each company must ensure that it has enough cash to pay its current obligations. However, it must recognize the fact that idle cash is a nonproductive resource.

- 2 Understand the importance of cash management.

2. *Accounting Trends and Techniques* (New York: AICPA, 2004), p. 150.

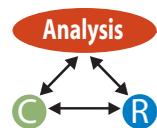
3. “Statements of Cash Flows,” *FASB Statement of Financial Accounting Standards No. 95* (Stamford, Conn.: FASB, 1987), par. 8.

Although a company may wish to protect itself against business failure by amassing a large amount of cash to keep itself liquid, it can improve its performance by investing these funds and earning interest. Proper cash management requires that a company invest its idle cash and estimate the timing of its cash inflows and outflows to ensure that it has enough cash to meet its needs. Having too much cash, however, may make a company the target of a takeover attempt.



Information on cash management is important in financial accounting because one objective of financial reporting is to communicate how well the managers of a company have fulfilled their stewardship responsibility to stockholders for the use of the company assets. In this regard, cash management includes planning and control aspects. **Cash planning** systems are those methods and procedures that a company uses to ensure that it has adequate cash available to meet maturing obligations and that it invests any unused or excess cash. **Cash control** systems are the methods and procedures a company uses to safeguard its funds.

A company's cash budget is the major component of its cash planning system. **The cash budget is a plan of cash activity that forecasts cash receipts and payments, and identifies when the company might have too much or too little cash.** The cash budget is primarily a managerial accounting technique and is outside the scope of this book.



Cash control systems require adequate internal control measures. **Internal control** is the process (policies and procedures) a company uses so that its financial reports are reliable, its operations (including safeguarding its assets) are effective and efficient, and that it complies with applicable laws and regulations.⁴ This control is so important that a federal law requires all publicly traded companies to maintain adequate internal control systems. Since cash cannot be traced easily, internal control over cash is enhanced by routine reviews of the accuracy of recorded cash transactions and by the separation of employee duties. These procedures help to prevent theft unless there is collusion among employees. However, whenever a company adopts internal control measures, the cost of using these measures should not exceed the value of the benefits. Any measure that costs more than its benefits ultimately will result in lower profits for the company.

Cash control systems can be subdivided into two main functions: (1) control over receipts and (2) control over payments. The control procedures a company adopts for its cash receipts should be designed to safeguard all cash inflows from the time they arrive at the company until they are deposited in its bank account. The key elements in a cash receipts internal control system are

- immediate counting of receipts by the person opening the mail or the salesperson using the cash register,
- daily recording of all cash receipts in the accounting records, and
- daily deposit of all receipts in the company's bank account.

The control procedures for payments should ensure that only authorized payments are made for actual company expenditures. The key elements in a cash payments internal control system include

- making all payments by check so there is a record for every company expenditure,
- authorizing and signing checks only after an expenditure is approved, and
- periodically reconciling the cash balance in the bank statement with the company's accounting records.

Two important elements of the internal control over cash are a petty cash system and a bank reconciliation. We discuss each of these elements in more detail in the Appendix at the end of this chapter.

4. For auditing purposes, a company's internal control structure consists of its control environment, risk assessment procedures, control activities, information and communication system, and monitoring process. For more detail, see *AICPA Professional Standards* vol. 1 (New York: AICPA, 2004), sec. 319.

Electronic-Based Payments

Many companies prepare and process hundreds or even thousands of checks each month to pay their suppliers and employees. Furthermore, they receive and process an equally large number of checks from their customers. Whether for payments or receipts, processing the paperwork for checks is expensive. With the increased use of computer networks, banks offer **electronic funds transfers (EFT)** to their customers. Under EFT, funds are transferred between companies electronically without the need of a check. EFT systems are becoming more compatible, and their networking capabilities are increasing. In addition to EFT systems, banks are also using accounts receivable conversion (ARC) and Check 21 (as we discussed at the opening of the chapter) for faster processing of “checks.” As more and more companies and banks use EFT, ARC, and Check 21 systems, fewer physical documents (e.g., checks) are processed. Therefore, greater emphasis is being placed on internal control systems as they apply to computer technology because fewer physical source documents are available to verify cash inflows and outflows.

Compensating Balances

It is common for banks to require a portion of any amount loaned to a company to remain on deposit in the bank (usually earning a low interest rate) for the loan period. These required deposits are called **compensating balances** because they “compensate” the bank for granting the loan. For example, a bank loaning a company \$100,000 may require that the company maintain a \$10,000 deposit with the bank until the company repays the loan. Such arrangements have two main effects. First, they reduce the amount of cash available to the borrower, and second, they increase the effective interest rate the borrower pays for the use of the funds. For example, if the stated interest rate for the \$100,000 loan is 12%, the effective rate for the actual funds used for a year is 13.33% ($\$12,000 \div \$90,000$), assuming the \$10,000 compensating balance does not earn any interest.

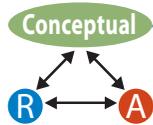
The SEC studied funds subject to these withdrawal or usage restrictions. This study was partially in response to *liquidity* problems that were reported by companies with apparently adequate cash balances. The SEC found many cases in which a portion of the reported cash balance was legally restricted. Therefore, it requires that a public company with a compensating balance against its short-term borrowings separately report the amount in the current assets section of its balance sheet. Compensating balances for long-term borrowings are separately reported as noncurrent assets (as either investments or other assets). Compensating balance agreements that do not legally restrict the amount of funds shown on the balance sheet are disclosed in the notes to the financial statements.



SECURE YOUR KNOWLEDGE 7-1

- To be reported as cash, the resource must be readily available to pay current obligations and may not be bound by any contractual or legal restrictions.
- Cash equivalents are short-term, highly liquid investments with a maturity date of three months or less from the date of purchase; they are often combined with cash for financial reporting purposes.
- A well-functioning cash management system ensures that a company has enough cash to fulfill its needs, invests any idle cash, and safeguards its cash receipts and cash payments.
- Compensating balances required in connection with loans serve to increase the effective interest rate on the loan and must be adequately disclosed.

RECEIVABLES



Receivables are amounts owed to the company by customers and other parties arising from the company's operations. Most receivables are canceled through the receipt of cash, although others may be canceled through the receipt of other assets or services. A company reports receivables on its balance sheet as either **current** or **noncurrent** items.

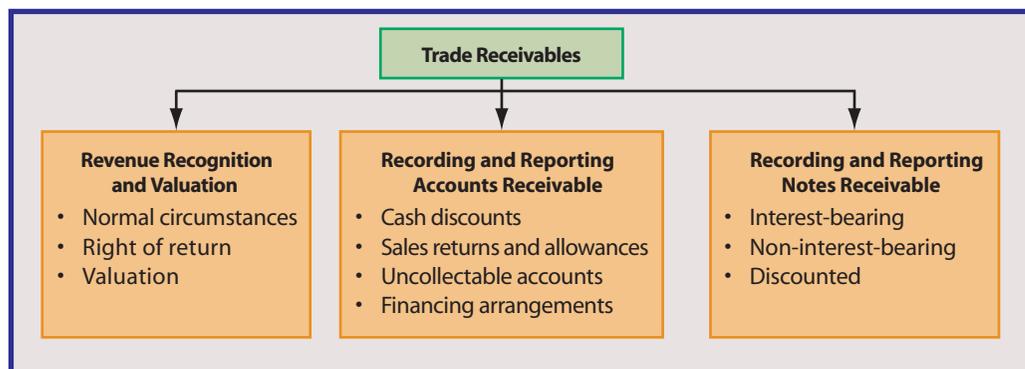
Those receivables expected to be collected within one year or the current operating cycle, whichever is longer, are classified as current assets; the remainder are classified as noncurrent. Also, a company may group receivables within its classified balance sheet as trade receivables and nontrade receivables.

Trade receivables arise from the sale of the company's products or services to customers. For instance, manufacturers may sell on credit to retailers (or other manufacturers), and retailers may sell on credit to consumers. Trade receivables generally are the majority of a company's total receivables balance. Trade receivables may be subclassified into **accounts receivable** (nonwritten promises by customers to pay for goods or services) and **notes receivable** (unconditional written agreements to receive a certain sum of money on a specific date). We discuss these subclassifications later in the chapter.

Nontrade receivables arise from transactions that are not directly related to the sale of the company's goods and services. Nontrade receivables are recorded in separate accounts. They are reported on the balance sheet in individual groups as current or noncurrent assets, depending upon the length of their collection period. Examples of nontrade receivables include deposits with utilities, advances to subsidiary companies, loans made by nonfinancial companies, deposits made to guarantee performance, and declared dividends and accrued interest on investments.

Utility companies often require a company to make a deposit to guarantee utility expense payments. This deposit normally is classified by the depositor as a noncurrent receivable because the timing of repayment by the utility company is indeterminate. An advance to a subsidiary typically is classified as long-term because repayment may be postponed indefinitely. A deposit made to guarantee contract performance is classified as either current or noncurrent, depending on the expected completion date of the project guaranteed. Declared dividends to be received and accrued interest on investments are disclosed as current assets. In this chapter we focus upon the valuation issues associated with current trade receivables. We discuss nontrade receivables and noncurrent receivables in other chapters in this book.

Accounting for trade receivables involves a number of issues. We include the following diagram to provide you with an overview of our related discussion.

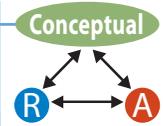


REVENUE RECOGNITION AND VALUATION OF TRADE RECEIVABLES

First, we look at several issues related to revenue recognition and receivables valuation.

Normal Revenue Recognition

A company usually makes sales of goods and services on “open accounts” that result in short-term extensions of credit. **A company records revenue from credit sales based on the revenue recognition criteria.** Revenue is recognized when **realization has occurred** (i.e., a noncash resource is exchanged for cash or a near cash resource) and the **revenue is earned** (i.e., the earning process is complete or virtually complete). Typically, the sale of goods and services on credit results in an asset called a trade receivable (account receivable or note receivable) and the recognition of revenue at the time of sale. This approach is used because the company expects to collect the asset (receivable), and very few activities remain in the earning process. However, in some cases a company may defer revenue recognition because it is not sure it will collect the receivable (which we will discuss in Chapter 18). In other cases, a company may defer revenue because a right of return exists.



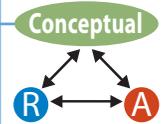
Right of Return

In most industries sales returns and allowances are not material, so that companies typically record them at the time of the return or allowance even if they occur in a period later than the period of sale. In some industries, such as book publishing, the right of return is common and the amounts may be material. In these cases, credit “sales” in one period may be followed by substantial returns in another. These factors create a revenue recognition issue for the selling company because sometimes (1) it cannot make reliable estimates of the collectibility of the receivable and (2) the risks and benefits of ownership are not transferred (the earning process is not complete) to the buyer. As a result, **FASB Statement No. 48 identifies criteria for recording sales revenue when the right of return exists. For a seller to recognize revenue at the time of sale, each of the following criteria must be satisfied when the right of return exists.** If they are not, then the seller must defer revenue recognition.

1. The sales price is known at the date of sale.
2. The buyer has paid or will pay the seller, and the obligation is not contingent upon resale of the product.
3. The buyer’s obligation to the seller would not be changed by theft or damage to the product.
4. The buyer has an economic substance apart from the seller.
5. The seller does not have significant obligations to help the buyer sell the product.
6. The seller can reasonably estimate the amount of future returns.⁵

If a company defers recognizing sales revenue and cost of goods sold because one or more of these conditions are not met, it records the sales revenue and cost of goods sold either when the return privilege expires or when the conditions are met, whichever occurs first.

3 Discuss revenue recognition when the right of return exists.



Valuation Issues

When the conditions in the previous section are met so that the company records a receivable and revenue at the time of sale, there still is an issue of valuing the trade receivable. As we discussed in Chapter 4, one purpose of reporting current assets is to disclose the **liquidity** of a company; that is, the “nearness to cash” of its economic resources. In this regard, the accounting issues related to the valuation of current trade receivables are (1) the initial recording of the receivables based on the total future cash flows, and (2) the estimation of the probability of collection. Since there is a time value of money,

5. “Revenue Recognition When Right of Return Exists,” *FASB Statement of Financial Accounting Standards No. 48* (Stamford, Conn.: FASB, 1981), par. 6.



there is a difference between the maturity value of a receivable and its present value. The longer the time until maturity, the greater the difference. **APB Opinion No. 21** (discussed in Chapter 15) provides specific guidelines for recording and reporting receivables at their present values. However, the provisions do not apply to “receivables . . . arising from transactions with customers . . . in the normal course of business which are due in customary trade terms not exceeding approximately one year.”⁶ Consequently **most trade receivables are recorded initially at their maturity values** and not at their present values. Also, since the collection period for most trade receivables is 60 days or less, the difference between their present value and maturity value is usually not material.

The uncertainty of collection also affects the value of trade receivables. Whenever a company extends credit, it may not collect a few receivables. The company should consider this issue in valuing its receivables on its balance sheet to report on their liquidity. We discuss the accounting procedures used to deal with the uncertainty of collecting receivables later in this chapter.

ACCOUNTS RECEIVABLE

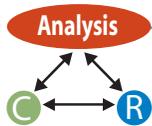
As we discussed earlier, trade accounts receivable result from credit sales. A company sells on credit in order to increase sales. But credit sales create the need for a credit department to investigate credit ratings, approve the extension of credit, and attempt to collect delinquent accounts. Credit sales result in a certain amount of bad debts due to nonpayment by customers. When a company considers whether or not to sell on credit, it must evaluate the trade-off between the additional gross profit received from the expected credit sales and the additional expenses incurred due to these credit sales. In this regard, most companies establish a credit policy.

A credit policy reflects the degree of risk a company is willing to accept to increase sales. Credit policies are closely associated with customers’ credit ratings. High credit ratings indicate low risk, whereas low credit ratings indicate high risk. A company should adopt a credit policy that results in the maximum increased profit consistent with maintaining customer satisfaction. That is, it should determine the combination of increased sales revenue and bad debt losses that results in the highest incremental profit and cash inflows. However, it should also consider other factors, such as the cost of additional sales and credit personnel to handle these increased sales. A few companies have decided that this trade-off is negative. These companies believe that they can lower costs and increase profits by selling exclusively for cash. Note that retail “credit card” sales involving bank credit cards are treated as cash sales, as we discuss later in the chapter.

If a company decides to sell on credit and establishes a credit department, it must install an effective internal control system for processing credit sales and cash collections. We discussed the internal control procedures used for cash collections earlier in the chapter, but a company must also establish internal control procedures for processing its accounts receivable. These control features include (1) prenumbered sales invoices so that all invoices are accounted for, and (2) the separation of the sales function from the cash collection responsibilities so that theft should not occur unless there is collusion between employees.

Once a company feels that a reasonable trade-off exists between the incremental revenues and expenses of credit sales, and has established an adequate system of internal control for credit sales, other issues may arise in recording accounts receivable. These issues include cash discounts and sales returns and allowances. We discuss uncollectible accounts (bad debts) in a later section.

4 Understand the credit policies and internal control related to accounts receivable.



6. “Interest on Receivables and Payables,” *APB Opinion No. 21* (New York: AICPA, 1971), par. 3.

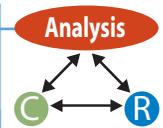
Cash (Sales) Discounts

Companies may offer a discount to induce prompt payment. This discount is called a **cash discount** (or **sales discount**) and frequently is expressed as 2/10, n/30 or perhaps 2/10, n/EOM (end of month). In both cases **the first component refers to the discount rate and period, and the second to the invoice due date**. These terms are read in the first case as: A 2% discount may be subtracted from the invoice price⁷ if payment is made by the purchaser within 10 days, and the total invoice price is due within 30 days. In the second example full payment is due by the end of the month. For example, assume that Company S sells \$5,000 of merchandise to Company B with terms of 2/10, n/30. If Company B pays for the merchandise within 10 days, it only has to pay \$4,900. This \$100 cash discount is a strong inducement to pay within the discount period because it is a relatively high effective annual interest rate for Company B. By paying within the discount period, Company B is giving up the use of funds for 20 days (that is, the invoice is due 20 days after the discount period expires) to earn a discount of 2%. This is approximately equal to an annual effective interest rate of 36% ($0.023 \times 60/20$).

Cash discounts are important in the financial management of companies. Both sellers and purchasers should carefully analyze the potential effects of cash discounts. As we noted, the theory behind cash discounts is that they will induce prompt payment. A purchasing company should take advantage of any cash discounts that have a higher effective annual interest rate than the rate it must pay to borrow money. For a selling company, a cash discount has two main positive effects: (1) it stimulates faster collection of cash for use in current operations, and (2) it tends to reduce the losses resulting from uncollectible accounts. However, the seller should not overlook the negative effect of its reduced total cash inflow because of the discount. Sellers should attempt to set the cash discount rate at a level so that its positive effects exceed any negative effects.

If a selling company extends cash discounts to its customers, it may use one of two methods (a “gross” method or a “net” method) to account for the discounts:⁸

1. *Accounts Receivable and Sales Recorded at Gross Price.* When the selling company uses the gross price method, it records the total invoice price in both the Accounts Receivable and Sales accounts at the time of sale as if no cash discount were involved. When the customer pays and takes the allowable cash discount, the company records the difference between the cash received and the original amount of Accounts Receivable as a debit to Sales Discounts Taken. If the customer does not take the cash discount, it pays an amount that is equal to the original balance in the company’s Accounts Receivable account, and no further adjustment is needed. Sales discounts taken are deducted from sales on the income statement to determine net sales.
2. *Accounts Receivable and Sales Recorded at Net Price.* When the selling company uses the net price method, it records the net invoice price (after deducting the allowable cash discount) in both the Accounts Receivable and Sales accounts at the time of sale. When the customer pays and takes the allowable cash discount, no adjustment is needed because the amount of cash received is equal to the recorded amount of the receivable. However, if the customer does *not* take the cash discount, it pays an amount that is greater than the amount in the company’s Accounts Receivable



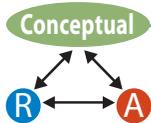
5 Explain the gross and net methods to account for cash discounts.

7. Another type of discount is the **trade** (or *quantity*) discount, which is offered for purchases in excess of a certain quantity. For example, if a company offers a 10% trade discount and a customer purchases 100 units of an item with a list price of \$80 per unit subject to the trade discount, the customer is billed \$7,200 [$\$8,000 - (0.10 \times \$8,000)$] as the invoice price. This \$7,200 invoice price then is subject to the cash discount.
8. In a third method, accounts receivable are recorded at the gross price, sales are recorded at the net price, and the difference is recorded in an allowance account (a contra account to accounts receivable). The allowance account then is reduced by the difference between the cash collected from the customer and the accounts receivable balance. It also is adjusted for sales discounts not taken.

account. The company credits this excess to an account entitled Sales Discounts Not Taken, which is interest revenue and is reported in the Other Items section of the income statement.⁹

To illustrate these methods, assume that the Howe Corporation sold \$8,000 of merchandise to various customers on December 4, 2007, with terms of 2/10, n/EOM. On December 13 Howe received payment on goods originally billed at \$5,500. Howe received payment on goods billed at \$1,500 on December 30. The remaining \$1,000 was not collected by the end of the year. Example 7-1 shows the journal entries to record these transactions and the year-end adjustments.

		Gross Price Method		Net Price Method	
To record sale on December 4, 2007	Accounts Receivable	8,000		Accounts Receivable	
	Sales		8,000	[\$8,000 - (0.02 × \$8,000)] Sales	7,840
					7,840
To record payment received on December 13, 2007	Cash			Cash	5,390
	[\$5,500 - (\$5,500 × 0.02)]	5,390		Accounts Receivable	
	Sales Discounts Taken	110			5,390
	Accounts Receivable		5,500		
To record payment received on December 30, 2007	Cash	1,500		Cash	1,500
	Accounts Receivable		1,500	Accounts Receivable	
				[\$1,500 - (\$1,500 × 0.02)]	1,470
				Sales Discounts Not Taken	30
To adjust the accounts at the end of the period	No entry required			Accounts Receivable	20
				Sales Discounts Not Taken	20



Conceptual Evaluation

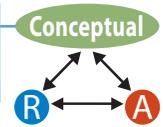
Theoretically the use of the net price method is sound because it values the accounts receivable at the net realizable value and also separates the amount of sales revenue from interest revenue. The gross price method has the advantage over the net price method of reporting receivable accounts at gross amounts, which simplifies communications with customers (because discussions are based on the gross amount). The gross price method also has the advantage of enabling sales returns and allowances (discussed later) to be recorded at gross instead of net amounts. But since a company expects most customers to take advantage of the cash discount, the gross price method overstates its current sales and accounts receivable at the end of the period. However, because the gross price method requires less record keeping, most companies use this method. Furthermore, when the timing of collections does not vary much from period to period, there is no material difference from using either method.

Sales Returns and Allowances

When a company sells merchandise, a few defective items may be returned by customers. In other cases contractual agreements also may allow products that are *not* defective to be returned. **When goods are sold that are found to be defective, the customer may retain**

9. At the end of the accounting period, an adjusting entry may be made for any cash discounts no longer available on the outstanding accounts receivable. This entry involves a debit to Accounts Receivable and a credit to Sales Discounts Not Taken. A reversing entry is usually made so that when these sales are collected, the collections may be recorded in the usual manner for when no discount is taken.

the goods and be allowed a reduction in the purchase price. This reduction is called a *sales allowance*. When the customer returns goods to the seller, the exchange is called a *sales return*. Often a sales return or allowance occurs in an accounting period after the sale. From a theoretical standpoint, if a company can make reliable estimates, it should record the estimated amount of future returns and allowances in the period of sale so as to correctly report net sales revenue and value ending accounts receivable.



To illustrate the accounting for sales returns and allowances, assume that the Barclay Corporation sells \$500,000 of goods during 2007 and the company estimates that returns and allowances will be 2% of sales. To anticipate the returns and allowances, the company records the following adjusting entry at the end of the period of sale (assuming it uses the gross price method of recording sales):

Sales Returns and Allowances (\$500,000 × 0.02)	10,000	
Allowance for Sales Returns and Allowances		10,000

Consequently, when sales returns and allowances of \$8,000 actually occur for goods sold on credit, the company records this transaction as follows:

Allowance for Sales Returns and Allowances	8,000	
Accounts Receivable		8,000

If the company used the net price method to record sales, it would base the preceding entries on the net price after deducting the cash discounts.

When a company estimates its sales returns and allowances in the period of sale, it includes any balance in the Allowance for Sales Returns and Allowances account on the balance sheet as a valuation account offset against Accounts Receivable. In cases where returns and allowances are not material, most companies do not estimate these items. Instead they record the returns and allowances on credit when they actually occur by debiting Sales Returns and Allowances and crediting Accounts Receivable (at the gross price or net price depending on which method they are using). Whether estimated or actual, a company reports sales returns and allowances on its income statement as a deduction from sales revenue.



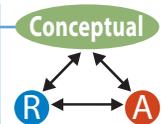
VALUATION OF ACCOUNTS RECEIVABLE FOR UNCOLLECTIBLE ACCOUNTS

The preceding discussion focused on the issues involved in initially recording trade accounts receivable. Not all accounts receivable will be collected, however. Some will become bad debts. A company might record uncollectible accounts (bad debts) by either of two procedures:

1. In the year of sale, based upon an estimate of the amount of uncollectible accounts, or
2. When it determines that a specific customer account is uncollectible.

FASB Statement No. 5 requires that companies estimate their losses from loss contingencies and deduct the amounts from income and assets when both of the following conditions are met:

1. Information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired at the date of the financial statements.
2. The amount of the loss can be reasonably estimated.¹⁰



10. "Accounting for Contingencies," *FASB Statement of Financial Accounting Standards No. 5* (Stamford, Conn.: FASB, 1975), par. 8.

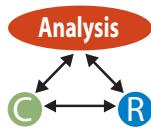
Since both conditions normally are met in regard to uncollectible accounts, most companies estimate bad debts. For instance, over 93% of surveyed companies reported estimates of bad debts on their financial statements.¹¹ This approach enables these companies to properly value their receivables and match expenses against revenues in the current period.

Allowance Method

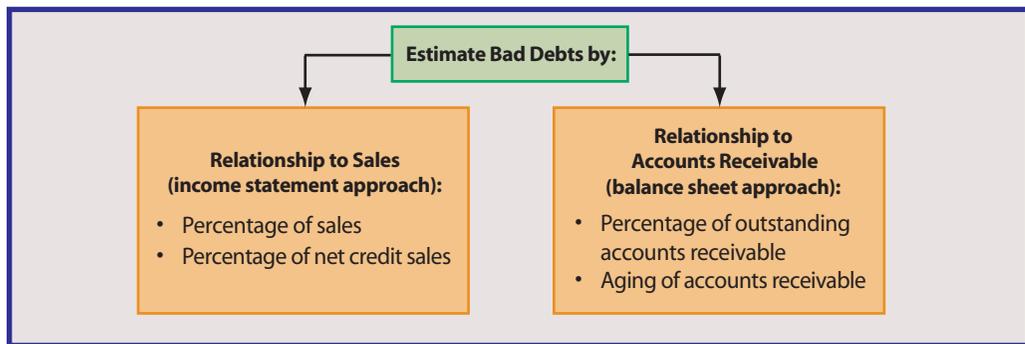
Under the **allowance method** a company studies the historical data about the actual bad debts it has incurred. It compares this information to its current sales or accounts receivable to determine relationships to use to estimate its current uncollectible accounts. **These relationships provide the information the company needs to prepare the adjusting entry to record the estimated bad debt expense for the period.**

When the company records the estimate of bad debts, the journal entry is a debit to Bad Debt Expense and a credit to Allowance for Doubtful Accounts (or, alternatively, Allowance for Bad Debts or Allowance for Uncollectible Accounts). A company normally reports bad debt expense on its income statement as an operating expense. However, some companies offset the account against gross sales, or report it as a financial expense in the Other Items section. The authors suggest reporting bad debt expense as an operating expense because it is similar to other operating expenses. Also, financial statement users normally expect companies to report bad debt expense in this manner.

Allowance for Doubtful Accounts is a valuation (contra) account that is offset against Accounts Receivable in the current assets section of the company's balance sheet. Although current credit sales create a likelihood of losses from bad debts, the company does not know at the time of sale which actual customer accounts will not be collected (if they were known, the company would not have extended credit to these customers). Offsetting Allowance for Doubtful Accounts against Accounts Receivable informs financial statement users of the net realizable value (the amount of cash expected to be collected) of the company's receivables.¹²



It is possible to base the estimate of bad debt expense on historical relationships between the actual bad debts incurred and (1) sales or (2) accounts receivable. These relationships may be classified as we show in the following diagram:



6 Estimate and record bad debts using a percentage of sales.

Percentage of Sales (or Net Credit Sales)

Estimating bad debts based on the historical relationship to sales matches current expenses against current revenues. This method is income statement oriented because it

11. *Accounting Trends and Techniques* (New York: AICPA, 2004), p. 177.
 12. If a company has other accounts, such as Allowance for Sales Returns and Allowances, Allowance for Sales Discounts, and Deferred Gross Profit, it also deducts these accounts from Accounts Receivable to determine the net realizable value.

is based on the matching principle. It results in recording bad debt expense in the period during which credit sales occur. A percentage of total sales may be used for the estimate when there is a stable relationship between cash and credit sales. However, if the proportion of credit sales to total sales varies from period to period, it is not appropriate to use a percentage of total sales in any given period. For this reason most accountants favor estimating bad debts based on the historical relationship between bad debts and net *credit* sales. For example, if Lema Company's net credit sales during the year were \$525,000 and bad debts have historically amounted to 2% of net credit sales, the company makes the following year-end adjusting entry:

Bad Debt Expense ($\$525,000 \times 0.02$)	10,500	
Allowance for Doubtful Accounts		10,500

Since this method focuses on an expense account, any existing balance in the allowance account is ignored when determining the amount of the adjusting entry. Also, if a company sells many products in different locations, it may choose to estimate bad debts based on the historical credit sales of particular products or in specific locations. Although basing bad debt expense on sales is a relatively straightforward income statement approach and adheres to the matching concept, it may not provide the best estimate of the net realizable value of accounts receivable. This is because the balance in the allowance account is ignored when making the adjusting entry. Also, if the company materially over (or under) estimates the net realizable value of the accounts receivable, a change in the accounting estimate may be necessary. Furthermore, it provides only limited information for the credit department to use in its collection activities. Because of these disadvantages a company may use a balance sheet approach.



LINK TO ETHICAL DILEMMA

As the accountant for SaveMart, the nation's largest retail company, you have performed an extensive analysis and estimated bad debts to be 3% of credit sales. While this estimate is slightly higher than last year's estimate of 2%, you feel the increase is warranted since the company, in an effort to stimulate sales, significantly relaxed its credit policy in the current fiscal year. However, if the 3% estimate is used, SaveMart's earnings will fall slightly below analysts' estimates. If the bad debt estimate is lowered to 2.5%, SaveMart will meet earnings expectations, and you will receive a large bonus. Because bad debt estimates have historically been between 2% and 3%, you are quite certain that the auditors will accept any estimate in this range. What are your responsibilities?

Percentage of Outstanding Accounts Receivable

Bad debts may be estimated based on the historical relationship between actual amounts not collected and accounts receivable. This approach is balance sheet oriented because the resulting accounts receivable is reported on the balance sheet at its estimated net realizable value. A relatively simple balance sheet approach is to base the estimated expense on the historical relationship between the actual bad debts and the outstanding accounts receivable balance at the end of the year.

In using this method, the goal is to determine the ending balance in Allowance for Doubtful Accounts. To determine the amount of its adjusting entry, a company must

consider the existing balance (prior to adjustment) in the allowance account. The company records Bad Debt Expense at the amount necessary to adjust the existing allowance account balance to the required ending balance. For example, assume that Weir Company has determined that historically there has been a 4% relationship between actual bad debts and the year-end accounts receivable balance. The company's accounts at the end of the year (prior to adjustment) are as follows:

Accounts Receivable	475,000
Allowance for Doubtful Accounts	4,500 (credit balance)

The expected net realizable value of Accounts Receivable is \$456,000 [$\$475,000 - (\$475,000 \times 0.04)$], and the required balance in Allowance for Doubtful Accounts is therefore \$19,000 ($\$475,000 - \$456,000$, or simply $\$475,000 \times 0.04$). However, since the current credit balance in the allowance account is \$4,500, only the amount necessary to increase the allowance account to its required ending balance is recorded as Bad Debt Expense. In this example the amount is \$14,500 ($\$19,000 - \$4,500$), as we show in the following T-account:

<u>Allowance for Doubtful Accounts</u>	
	4,500 (current balance)
	14,500 (required adjustment)
	19,000 (required ending balance)

Based on the preceding information, Weir Company records the following year-end adjusting entry:

Bad Debt Expense	14,500	
Allowance for Doubtful Accounts		14,500

A potential weakness of basing bad debts on a percentage of total outstanding accounts receivable is that it does not consider the due date of the many individual accounts comprising the total balance. This weakness is overcome by "aging" the accounts receivable.

Aging of Accounts Receivable

7 Estimate and record bad debts using an aging analysis.

The length of time an account is outstanding is important in estimating the probability of its future collection. A company is much more likely to collect an account that is 20 days old than one that is 360 days old. For this reason a more sophisticated method of estimating bad debts as a percentage of accounts receivable is used. A company that "ages" its accounts receivable first classifies the individual accounts based on the length of time they have been outstanding, and then applies an historically developed bad debts percentage to each age category. This information is available from the company's accounts receivable subsidiary ledger. The information in Example 7-2 is taken from the accounts receivable subsidiary ledger of the Rhorke Corporation and illustrates how bad debts are estimated with the use of an *aging schedule* (or aging analysis).¹³

In developing the aging schedule, the company reviewed the unpaid invoices in each customer's account, classified the invoice amounts according to the length of time the invoice has been outstanding, and totaled the amounts in each group. It then multiplied the total amount in each age group by the applicable estimated uncollectible percentage to determine the estimated amount uncollectible for that age group. It determines the

13. A company with few accounts receivable would probably not find an aging analysis to be a useful procedure, because each customer could be evaluated individually. Aging is appropriate when there are large numbers of customers who cannot reasonably be evaluated individually at the end of the period. In this example, for simplicity, only a few customers are used.

EXAMPLE 7-2 Aging Analysis

Rhorke Corporation
December 31, 2007

(a) Aging Schedule of Accounts Receivable

Customer	Length of Time Outstanding					
	Balance 12/31/07	Under 60 Days	60–120 Days	121–240 Days	241–360 Days	Over 1 Year
Goodwin Co.	\$ 33,100	\$21,000	\$12,100			
Hobson Inc.	14,500					\$14,500
Lomas Manufacturing	20,600	15,000	5,600			
McClendon Co.	15,700				\$15,700	
Schauer Corporation	37,900	17,500	16,800	\$3,600		
	<u>\$121,800</u>	<u>\$53,500</u>	<u>\$34,500</u>	<u>\$3,600</u>	<u>\$15,700</u>	<u>\$14,500</u>

(b) Estimated Uncollectibles

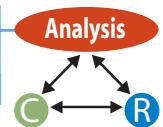
Age	Amount	×	Estimated Percentage Uncollectible	=	Estimated Amounts Uncollectible
Under 60 days	\$ 53,500		2%		\$ 1,070
60–120 days	34,500		8		2,760
121–240 days	3,600		15		540
241–360 days	15,700		30		4,710
Over 1 year	14,500		50		7,250
	<u>\$121,800</u>				<u>\$16,330</u>

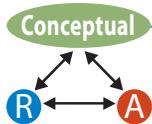
total estimated uncollectible amount by adding the estimated uncollectible amounts related to each age group.

This analysis indicates that the ending balance of Allowance for Doubtful Accounts should be \$16,330 on December 31, 2007. Since the objective in an aging analysis is to determine the ending allowance account balance, a company also considers the previous balance of the allowance account in recording the amount of bad debt expense at the end of the period. If Rhorke has a current \$1,350 *debit* balance in its allowance account, the amount of recorded expense necessary to bring the allowance account up to its required balance is \$17,680 (\$16,330 + \$1,350). Note that in this case the current *debit* balance in its allowance account is added. (We discuss the events that might cause the allowance account to have a debit balance in the next section.) A credit balance would be *subtracted* to determine the necessary adjustment amount. Based upon the preceding calculations, Rhorke makes the following year-end adjusting entry:

Bad Debt Expense	17,680	
Allowance for Doubtful Accounts		17,680

Use of the aging method, particularly when the company prepares interim (monthly) financial reports, is very helpful to its credit department. As it prepares each new aging schedule, this method focuses attention on any accounts that have not been collected and that have shifted to an older age category. Frequently, a company will compute its “receivables turnover” (net credit sales ÷ average net accounts receivable) along with its aging schedule, to determine how efficient it is in collecting its accounts receivable. The aging method has the advantage of properly reporting the net realizable value of accounts receivable on the balance sheet and of providing useful information to the credit department. However, it may not precisely match bad debt expense against revenue in the year of sale.





Conceptual Evaluation

In summary, a company should estimate and record bad debt expense in the period of sale rather than record bad debts as accounts are written off. There are two main approaches to estimating bad debts. **The income statement approach, in which a percentage of sales (or net credit sales) is used, results in a matching of expenses with sales in the current period.** However, this approach may not report accounts receivable at their net realizable value, because it does not consider the age of the individual accounts. **The balance sheet approach, which uses a percentage of outstanding accounts receivable or an aging analysis for estimating bad debts, results in reporting accounts receivable at their expected net realizable value on the balance sheet.** Also, the aging analysis provides useful credit information. With the FASB's concern for reporting on a company's *liquidity* and *future expected cash flows*, the balance sheet method may be more appropriate. Currently, both methods are used in practice, and both are allowed under generally accepted accounting principles.

1/3 LINK TO RATIO ANALYSIS

Cash is the lifeblood for any company and often results from billing and collecting credit sales. Therefore, many managers and investors carefully monitor accounts receivable to gain insight into future profitability and cash flow. The receivables turnover ratio (net credit sales ÷ average net receivables) is one measure often used as an indicator of the efficiency with which a company collects its receivables and converts them back to cash. Using data obtained from the **Walt Disney Company's** annual report, the receivables turnover computation is shown in the following table:

(amounts in millions)	2004	2003	2002
Receivables (net)	\$ 4,558	\$ 4,238	\$4,049
Net Revenues	\$30,752	\$27,061	

$$2004: \text{Receivables Turnover} = \frac{\$30,752}{\left(\frac{\$4,558 + \$4,238}{2} \right)} = 6.99$$

$$2003: \text{Receivables Turnover} = \frac{\$27,061}{\left(\frac{\$4,238 + \$4,049}{2} \right)} = 6.53$$

Disney turned its receivables over 6.99 and 6.53 times per year for fiscal years 2004 and 2003, respectively. Dividing the turnover ratio into 365 days, it appears that it took Disney, on average, 52.2 days and 55.9 days to collect its accounts receivables in 2004 and 2003, respectively. Overall, it appears that over the two-year period examined, Disney was successful at speeding up the collections of receivables and, as a result, had fewer resources tied up in receivables.

Writing Off Uncollectible Accounts

If a company records bad debt expense based on an estimate, it writes off an individual account when it determines that the account is uncollectible. The journal entry is a debit

to Allowance for Doubtful Accounts and a credit to Accounts Receivable. This write-off is simply an adjustment required because the company has confirmed a previously estimated expense. The write off does not affect the carrying value of the accounts receivable on the balance sheet. Consider the following information for Shy Company:

Accounts Receivable	\$175,000
Allowance for Doubtful Accounts	8,750 (credit balance)
Customer account determined to be uncollectible	1,000

At the time of the write-off, the company makes the following journal entry:

Allowance for Doubtful Accounts	1,000	
 Accounts Receivable		1,000

This write-off has *no effect* on the net realizable value of the accounts receivable because the allowance account and the accounts receivable balance are reduced by the same amount. As shown in the following schedule, before the write-off the net realizable accounts receivable was \$166,250 (\$175,000 – \$8,750). After the write-off the net carrying value of the accounts receivable is still \$166,250, but it now consists of a \$174,000 accounts receivable balance and a \$7,750 allowance account balance. Similarly, there is no effect on the income statement as a result of this write-off because it did not involve a revenue or expense account.

	Before Write-off	Write-off	After Write-off
Accounts receivable	\$175,000	\$(1,000)	\$174,000
Less: Allowance for doubtful accounts	<u>(8,750)</u>	1,000	<u>(7,750)</u>
Net realizable value	\$166,250		\$166,250

A company records its write-offs of accounts receivable when it determines the individual accounts that are uncollectible. Occasionally write-offs occur during the period of sale *prior to* recording the estimated bad debts at the end of the period. In these cases the journal entry for the write-off is the same as shown previously: a debit to Allowance for Doubtful Accounts and a credit to Accounts Receivable. This entry may cause a *debit* balance in Allowance for Doubtful Accounts prior to the year-end adjustment. When the company is using a balance sheet approach, the debit balance is considered in determining the amount of the adjusting entry. When the income statement approach is used, a debit (or credit) balance is ignored (unless it becomes significant). Additionally, estimates always involve future uncertainties, and the actual losses incurred from bad debts may be greater than the amount of estimated expense. As new information becomes available, a company may need to change its estimated percentage of bad debts. If the company uses the balance sheet approach, it modifies the balance of the allowance account each year based on the most current information. When a company changes the estimated percentage of bad debts, it treats this change as an adjustment of bad debt expense in current and future periods. This change is considered to be a change in estimate as defined by *FASB Statement No. 154*. We discuss changes in estimates in Chapter 23.

Collection of an Account Previously Written Off

Occasionally a company will receive payment from a customer whose account it has already written off. Most accountants favor reestablishing the customer's account receivable in the subsidiary ledger and then recording the payment. This procedure has the advantage of providing a complete credit history for each customer account and also eliminates the previous write-off entry. For example, if Uphoff Company receives a \$300

payment from a customer whose account it had previously written off, the company makes the following journal entries:

Accounts Receivable	300	
Allowance for Doubtful Accounts		300
Cash	300	
Accounts Receivable		300

Note that the first entry “reverses” the initial write-off and the second entry records the cash collection in the usual manner. Also note that both entries to accounts receivable are also recorded in the customer’s account in the subsidiary ledger.

Direct Write-Off Method

The second method of recording uncollectible accounts is called the direct write-off method. This method has the advantages of simplicity and of reporting actual bad debts expense rather than an estimate. **When a company uses the direct write-off method, it records bad debt expense when it determines that a specific customer account is uncollectible.** At that time it writes off the account by debiting Bad Debt Expense and crediting Accounts Receivable. However, this determination and write-off may not occur until a later period than the period of sale. The use of the direct write-off method has the disadvantage of matching the bad debt expenses associated with previous sales against revenues of the current period. It also overstates accounts receivable associated with previous sales. Furthermore, it allows the manipulation of income because management selects the period of write-off (and expense). For these reasons the direct write-off method is not allowed under generally accepted accounting principles. However, some companies use it for financial reporting because they are required to use it for income tax purposes and the results do not differ materially from those obtained under the estimated methods we discussed earlier.



SECURE YOUR KNOWLEDGE 7-2

- Revenue from credit sales is normally recognized at the time of sale; however, if collectibility of the receivable is not reasonably assured or if a right of return exists, revenue recognition may be deferred until a later period.
- Accounts receivable are normally reported at the amount the company expects to receive (net realizable value).
- Cash discounts taken are recorded as a reduction of net sales; however, cash discounts *not* taken are left in sales (gross method) or recorded as interest revenue (net method).
- If sales returns and allowances can be reliably estimated, they should be recorded as a reduction in net sales and net receivables in the period of the sale.
- Because bad debt expense is a cost of granting credit, the matching principle requires that this expense be estimated and recorded in the period of the credit sale.
- Bad debt expense may be estimated as a percentage of sales (an income statement approach) or through an analysis of accounts receivable (a balance sheet approach).
- The write off of an uncollectible account under the allowance bad debt method does not affect the carrying value of net accounts receivable.

GENERATING IMMEDIATE CASH FROM ACCOUNTS RECEIVABLE

The net realizable value of the accounts receivable reported on a company’s balance sheet is usually the amount of cash the company expects to collect in its normal operating

cycle. However, in some circumstances a company may find that it needs to accelerate the cash inflows from its accounts receivable.

In today's business environment there are many companies that specialize in "financing" other companies' accounts receivable. These finance companies include, for instance, **General Motors Acceptance Corporation (GMAC)**, **Ford Motor Credit Company (Ford Credit)**, and **General Electric Capital Services (GECS)**, as well as credit card companies such as VISA, MasterCard, American Express, and Diner's Club. There are many variations in financing arrangements, including which receivables are involved, which company collects the receivables, who has title, and who incurs bad debts.

In this section we discuss the accounting issues faced by a company that "transfers" its accounts receivable to a financing company in exchange for cash. For financial reporting, these issues involve revenue recognition and asset valuation. For **revenue recognition**, the issue relates to whether the risks of ownership of the receivables have been transferred (so revenue should be recognized). For **asset valuation**, the issue relates to who has control over the future benefits from the receivables (to determine who "owns" the asset). In addition, reporting on these types of arrangements provides important information about a company's **liquidity**, the nearness to cash of its receivables; and **financial flexibility**, its ability to use its receivables to adapt to changing financial conditions.

There are three basic forms of financing agreements to obtain cash from accounts receivable: (1) **pledging**, (2) **assigning**, and (3) **factoring (sale)**. There may be variations in the conditions of each agreement so that the distinctions are not always clear-cut.¹⁴ These agreements are evaluated on a "continuum," based on the transfer of risks of ownership and control over the benefits of the receivables, as we show in Exhibit 7-1.

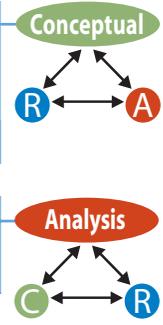


EXHIBIT 7-1 Accounts Receivable Financing Agreements		
Retain Risks and Benefits of Ownership	Transfer Some Risks and Benefits of Ownership	Transfer Risks and Benefits of Ownership
Pledge	Assign	Factor
(Collateral for Loan)	(Specific Receivables with Recourse)	(Sale without Recourse)

The FASB addressed these issues in **FASB Statement No. 140** related to financing agreements. It concluded that a company (transferor) records the transfer of financial assets (e.g., accounts receivable) in which it surrenders control over the financial assets to another company (the transferee) as a sale when *all* the following conditions are met:

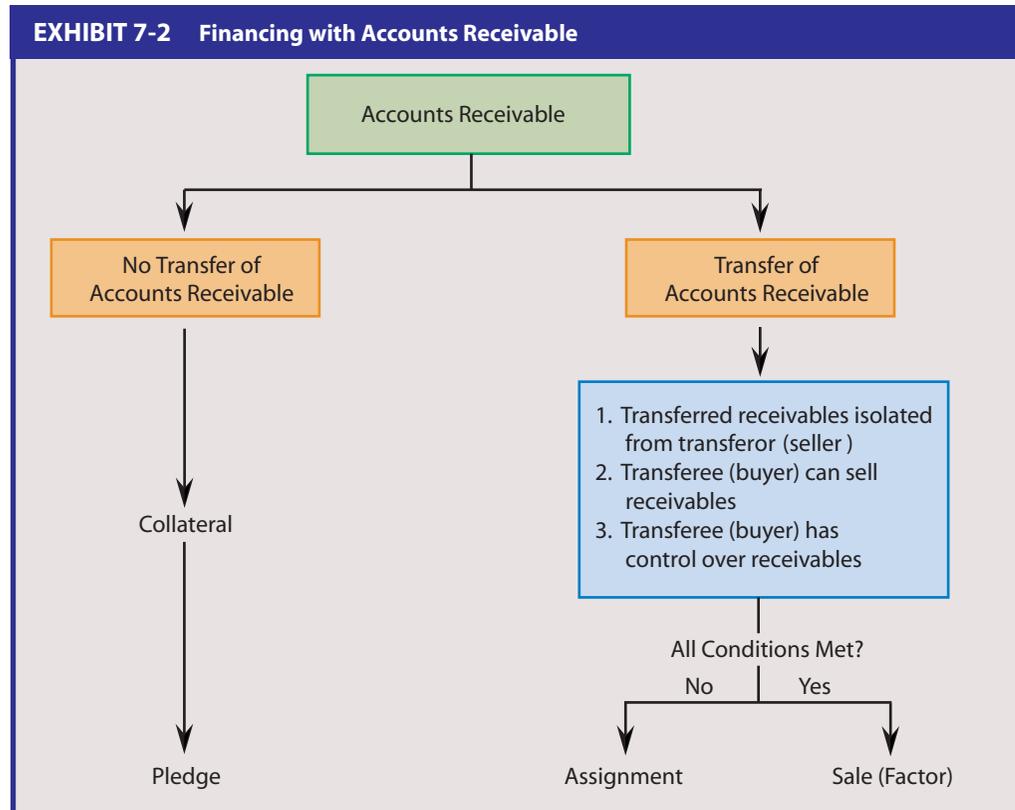
1. The transferred assets have been isolated from the transferor (i.e., put beyond the reach of the transferor).
2. The transferee obtains the right to exchange (e.g., sell) the transferred assets.
3. The transferor does not maintain effective control over the transferred assets through an agreement in which it can repurchase the transferred assets before their maturity.

If financial assets are transferred, the transferor continues to report on its balance sheet any retained interest in the transferred assets. If the transfer meets the conditions for a sale, the transferor records the proceeds, eliminates the financial assets, and records a

14. For a broad discussion, see "Asset Securitization: Economic Effects and Accounting Issues," *Accounting Horizons* (March 1992), pp. 5-16.

gain or loss. If the conditions for a sale are *not* met, the transferor records the proceeds from the transfer of financial assets as a secured borrowing.¹⁵

Of 600 surveyed companies nearly 26% reported pledging, assigning, or factoring their accounts receivable.¹⁶ Exhibit 7-2 briefly shows how to determine whether to account for an accounts receivable financing agreement as a pledge, assignment, or factor (sale). We discuss the specific accounting for these three arrangements in the following sections.



Pledging of Accounts Receivable

8 Explain pledging, assignment, and factoring of accounts receivable.

When a company *pledges* its accounts receivable, it is using these accounts only as collateral for a loan, and the servicing activities remain its responsibility. (*Servicing activities* are the routine collection and administration functions.) The company records the loan as a liability in the usual manner. Then when it collects the receivable, it uses the cash to repay the loan plus any interest charges. Upon full payment of the loan the pledge is canceled. If the company defaults, the lender has the legal right to take title to the pledged receivables and sell them to recover the amount of the loan. Pledge agreements usually are not formally entered in a company's accounting records because there is no transfer of risk, and the company retains control over the receivables. A company generally discloses these agreements parenthetically or in the notes to its financial statements to indicate that a portion of the accounts receivable balance may not be available to general creditors.

15. "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities," *FASB Statement of Financial Accounting Standards No. 140* (Norwalk, Conn.: FASB, 2000), par. 9–12.

16. *Accounting Trends and Techniques* (New York: AICPA, 2004), p. 173.

Assignment of Accounts Receivable

When a company *assigns* its accounts receivable to a financial institution, it enters into a lending agreement with the institution to receive cash on specific customer accounts. Frequently, these are long-term agreements. Assignment agreements can be very complex and involve issues such as interest rate swaps, call options, and unique servicing charges, as addressed in *FASB Statement No. 140*. Here, we discuss basic assignment agreements. Under a basic assignment agreement, the borrowing company (assignor) usually retains ownership of the assigned accounts, incurs any bad debts, collects the amounts due from customers, and uses these funds to repay the loan. Occasionally, the financial institution (assignee) will require the assigned accounts to make their payments directly to it (this procedure is called *notification*). The assignee may impose collection guidelines on the assigned accounts or may agree to share in the risks of nonpayment. In these cases some of the risks and control of ownership are transferred to the assignee. This is the major difference between assigning and pledging accounts receivable. Since the assignor (borrowing company) usually retains the risks of ownership, accounts are assigned *with recourse*. This means that if the cash collected from the accounts is not enough to repay the amount owed by the assignor, the assignee still can demand payment from (has recourse against) the assignor. This is the major difference between assignment agreements and factoring agreements, where the receivables are sold without recourse and the buyer assumes all the risks of ownership.

In assignment agreements the assignor company's relationship with the purchasers of its goods and services is not disrupted because the purchaser usually makes payments directly to the company (*non-notification*) and is unaware of the financing arrangement. Usually, the amount of receivables assigned is greater than the amount of the advance; the excess amount protects the assignee from sales returns and allowances. Under assignment arrangements the assignor pays a service charge and interest on the loan, and makes periodic payments (including interest) to the assignee based on collections of assigned accounts receivable. The assignor is also required to absorb any reductions due to sales returns and allowances or losses from uncollectible accounts. On the assignor company's balance sheet, it reports assigned accounts receivable separately from unassigned accounts receivable because it must use cash receipts from these assigned receivables for a specific purpose. That is, some of the benefits of ownership of the asset are transferred to the assignee. The assignor company reports the note payable as a current or noncurrent liability, depending on the due date.

Example: Assignment

Assume that on December 1, 2007, the Trussel Company assigns \$60,000 of its accounts receivable to a finance company. The finance company advances 80% of the accounts receivable assigned less a service charge of \$500. It also charges an annual interest rate of 12% on any outstanding loan balance. The journal entries that Trussel makes to record this assignment are:

Cash $[(\$60,000 \times 0.80) - \$500]$	47,500	
Assignment Service Charge Expense	500	
Note Payable $(\$60,000 \times 0.80)$		48,000
Accounts Receivable Assigned	60,000	
Accounts Receivable		60,000

The first journal entry records the receipt of cash. The Assignment Service Charge Expense account is a cost of borrowed funds and most companies usually record it as an expense at the time of the advance. The second journal entry reclassifies the receivables as assigned accounts receivable.

On December 31, 2007, Trussel collects \$10,000 on assigned accounts. It pays this amount along with the 12% interest for 1 month to the finance company. Trussel records these transactions as follows:

Cash	10,000	
Accounts Receivable Assigned		10,000
Note Payable	10,000	
Interest Expense ($\$48,000 \times 0.12 \times 1/12$)	480	
Cash		10,480

The interest expense on any future payments is based upon the balance *remaining* in the Note Payable account (for example, the interest expense for the next payment in our example is based on the \$38,000 note payable balance). During the period the note is outstanding, Trussel credits any bad debt losses and sales returns and allowances related to the assigned accounts receivable against the Accounts Receivable Assigned account. After Trussel pays the note, it reclassifies any remaining balance in Accounts Receivable Assigned as Accounts Receivable.

On the December 31, 2007 balance sheet of the Trussel Company, it reports the assigned accounts and the remaining liability (assuming it is short-term) as follows:

<i>Current Assets</i>		<i>Current Liabilities</i>	
Accounts receivable assigned	\$50,000	Note payable	\$38,000

Trussel includes a description of the financing agreement in the notes to its financial statements. ♦

Factoring (Sale) of Accounts Receivable

When a company factors its accounts receivable, it sells individual accounts to a financial institution (called a factor). Since the company *sells* the receivables, it transfers title to the factor who assumes all the risks of ownership. That is, the company sells the accounts receivable *without recourse*, which means that if any receivables are not collected the factor cannot demand payment from it. Consequently, factoring agreements focus on control of the receivables and usually require (1) notification of the credit customers to remit the amounts owed directly to the factor, and (2) assumption by the factor of all collection activities, setting of credit policies, and losses from uncollectible accounts.

At the time of sale the factor (finance company) charges the selling company a commission. The commission usually is based on the amount of receivables transferred and is relatively high, although it varies depending on the risk of noncollection. The way in which the selling company records the commission depends on its normal operating activities. A selling company records the commission as an *expense* if it normally factors its accounts receivable, or as a *loss* if it usually does not sell its accounts receivable. In addition to charging a commission, the factor usually will pay only 80% to 90% of the value of the accounts receivable transferred, as a protection against sales returns and allowances. The selling company records the amount withheld (i.e., the 20% to 10%) in a separate Receivable from Factor account to indicate the amount that may be returned by the factor. Since title is transferred, the selling company reduces (credits) Accounts Receivable for the amount of the receivables sold.

Example: Factoring

Assume that the Farber Corporation sells \$80,000 of accounts receivable to a factor, receives 90% of the value of the factored accounts, and is charged a 15% commission

based on the gross amount of factored accounts receivable. Farber records the following journal entry (assuming that it normally factors its accounts receivable):

Cash $[(\$80,000 \times 0.90) - \$12,000]$	60,000	
Receivable from Factor $(\$80,000 \times 0.10)$	8,000	
Factoring Expense $(\$80,000 \times 0.15)$	12,000	
Accounts Receivable		80,000

If sales returns or allowances occur on factored accounts, the selling company debits Sales Returns and Allowances and credits Receivable from Factor. At the conclusion of the factoring agreement for a particular group of receivables, the selling company collects any balance remaining in the Receivable from Factor account from the factor and debits Cash and credits Receivable from Factor. When a factoring agreement exists, the selling company discloses the agreement in a note to its financial statements. Factoring agreements are common in the furniture and textile industries; another common example is the sale of home mortgages from one financial institution to another. However, many companies are reluctant to use factoring agreements because of the cost of notifying their customers, and because their customers may dislike being required to make payments to a bank or finance company rather than to the seller. ♦

Credit Card Sales

Many retail companies make agreements with national credit card companies, which operate either independently or in affiliation with banks. Among the most popular are VISA, MasterCard, American Express, and Diner’s Club. Under these arrangements, card holders establish a **line of credit** (with the credit card company) which may be used for retail purchases of goods and services. After customers make credit purchases, the retailer deposits the credit card receipts in its bank account (or receives an electronic transfer of cash from the credit card company). The customers then repay the bank or credit card company. These types of agreements are *factoring* agreements.

The retailer accepting these credit cards charges its customers the selling price for goods and services, but is assessed a service charge on credit card sales by the bank or credit card company. This charge is usually a percentage of each sale, and the fee is for the use of a credit and collection department. Thus, the retailer usually records the fee as an operating expense. The individual retailer assumes little or no risk in accepting national credit cards, because most risk is borne by the bank or credit card company (except where there is fraud or negligence by the retailer) since the bank or credit card company originally granted the line of credit. The service charge assessed on credit card sales usually varies between 1 and 5% and is partially determined by the annual amount of sales or by exclusive arrangements. In an **exclusive arrangement** a retailer will accept only one national credit card, and in return the credit card company charges the retailer a lower service charge. For example, **Sam’s Club** accepts only Discover cards in its stores.

For example, assume that Kerns Shoes sold \$1,500 of merchandise on credit which was billed to a national credit card company. If the collection fee charged by the credit card company is 5%, Kerns makes the following journal entry when it deposits the credit card sales receipts (assuming it is using the gross price method of recording sales):

Cash	1,425	
Credit Card Expense $(\$1,500 \times 0.05)$	75	
Sales		1,500

Some large retailers (e.g., Sears, JCPenney) have their own credit cards. When a customer makes a credit purchase using a retail company’s credit card, the company records accounts receivable in the usual manner.

Disclosure of Financing Agreements of Accounts Receivable

As we noted in the previous discussion, a company should disclose the existence of pledge, assignment, or factor (sale) agreements parenthetically or in the notes to its financial statements. An example of this type of disclosure for a factoring agreement is shown in the first note of UNIFI, Inc., 2004 financial statements in Real Report 7-2.



Real Report 7-2 Disclosure of Factoring Agreement

UNIFI, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN PART)

1. Accounting Policies and Financial Statement Information (in part)

Receivables: . . . Prior to March 28, 2004, certain customer accounts receivable were factored without recourse. Effective March 26, 2004, the Company ended its factoring relationships due to the cost savings derived from in-house collections. The remaining factored receivables at June 27, 2004 were \$0.8 million compared to \$20.1 million at June 29, 2003. An allowance for losses is provided for known and potential losses arising from yarn quality claims and for amounts owed by customers that are not factored. . . . The reserve for such losses was \$10.7 million at June 27, 2004 and \$12.3 million at June 29, 2003.

Questions:

1. Why didn't UNIFI provide an allowance for losses on the accounts receivable that it factored?
2. Why did UNIFI end its factoring relationships?

NOTES RECEIVABLE

A note receivable is an unconditional written agreement to collect a certain sum of money on a specific date. Notes receivable generally have two attributes that accounts receivable do not have:

1. They are negotiable instruments, which means that they are legally transferable among parties and may be used to satisfy debts by the holders of these instruments.
2. They usually involve interest, requiring the separation of the receivable into its principal and interest components.

Companies frequently require their customers to issue notes receivable when the customers wish to extend the repayment period on an account receivable. Sometimes a company may require notes receivable when it extends credit to new customers, and in some cases it may require them for all credit sales. Notes receivable also may result from long-term contracts.

A company may receive two types of short-term notes: (1) those bearing interest on the face amount of the note and (2) non-interest-bearing notes. We discuss these short-term notes in the following sections. We discuss recording long-term notes at their fair (present) value in Chapter 14.

Short-Term Interest-Bearing Notes Receivable

When an interest-bearing note is issued, the amount borrowed (the principal) is listed as the face value, and the interest charged is stated as a specific rate applied to this face value. When a company receives a note, it debits the Note Receivable account for the face value. After issuance, it records interest revenue on the note in the usual fashion, including any year-end adjustments for interest receivable. To illustrate, assume that on October 1, 2007, Trent Company made a \$5,000 credit sale to Jaynik Company and required the company to sign a \$5,000, 60-day, 12% note. The middle column of Example 7-3 shows the journal

9 Account for short-term notes receivable.

EXAMPLE 7-3 Accounting for Short-Term Notes Receivable

	Interest-Bearing		Non-interest-Bearing	
To record receipt of note on October 1, 2007	Notes Receivable	5,000	Notes Receivable	5,100
	Sales	5,000	Interest Revenue	100
			Sales	5,000
To record receipt of maturity value on December 1, 2007	Cash	5,100	Cash	5,100
	Notes Receivable	5,000	Notes Receivable	5,100
	Interest Revenue*	100		

*\$5,000 × 0.12 × 60/360

entries on October 1, 2007 for the Trent Company to record the receipt of the interest-bearing note, and on December 1, 2007 to record the receipt of the principal and interest (assuming, for simplicity, a 360-day business year). If the note had extended past the end of the year, Trent Company would have made a year-end adjusting entry to record the interest receivable and recognize the interest revenue.

Bad debt losses may occur on transactions involving short-term notes receivable, particularly when it is common practice to require customers to sign notes for all credit sales. In these cases the company should assess the likelihood of these losses and establish an Allowance for Doubtful Notes. This procedure is the same as we discussed earlier for accounts receivable and results in an increase in its expenses and a decrease in the net realizable value of its notes receivable.

Short-Term Non-Interest-Bearing Notes Receivable

In the case of a non-interest-bearing note, the maturity value (the amount to be collected, which includes both principal and implicit interest) is listed as the face value. Actually the term non-interest-bearing is a misnomer because all notes implicitly include interest. It is simply a case of the interest being included in the face value rather than being stated as a separate rate. A better term would be a note with no *stated interest rate*. *APB Opinion No. 21* does not require current trade receivables to be recorded at their present values because the difference between the present value and the maturity value is not likely to be significant. Consequently, many companies record short-term non-interest-bearing trade notes receivable at their maturity values. This approach, however, overstates sales revenue and understates interest revenue.

A conceptually better approach is to record the note receivable at its present value and to recognize interest revenue as it is earned. To illustrate, assume the same facts as in the earlier example except that Jaynik Company signs a \$5,100 non-interest-bearing note, due on December 1, 2007. The top of the right column of Example 7-3 shows the journal entry on October 1, 2007 for the Trent Company to record the receipt of the non-interest-bearing note. Observe in this entry that interest revenue is credited¹⁷ for \$100. Although technically the company has not yet earned the interest, it will do so before the end of the accounting period. This procedure simplifies the accounting process. The journal entry on December 1, 2007 to record the receipt of the face value is shown at the bottom of the right column of Example 7-3. If the note had extended past the end of the year, Trent Company would have made a year-end adjusting entry to *reduce* (debit) the interest revenue for the interest not yet earned and to adjust (credit) an account entitled Discount on Notes Receivable. This Discount account is a contra account and is deducted from the Notes Receivable account to report the net realizable value on the balance sheet.

17. Alternatively, Discount on Notes Receivable could be credited (instead of Interest Revenue) at the time of issuance. Then, when the face value is collected (or at year-end if an adjustment is required), a journal entry must be made to reduce the discount account and increase interest revenue for the amount of interest earned.

Notes Receivable Discounted

Occasionally a company may find that it needs additional cash on a short-term basis, but the company does not wish to borrow money or sell or assign its accounts receivable. In these cases the company may discount a customer's note receivable at a bank in return for cash. **When a company discounts a customer's note receivable at the bank, it transfers the note to the bank.** This financing arrangement is subject to the conditions of *FASB Statement No. 140* summarized in Exhibit 7-2. If all the conditions are met, the company records the transfer as a sale (without recourse). If the conditions are not met, the company records the transfer as an assignment (with recourse). Typically, the customer is notified to pay the bank directly on the maturity date. If the agreement is an assignment with recourse, there is a contingent liability during the period between the discount date and the maturity date. During this period, the company must disclose the assignment in the notes to its financial statements, even if the possibility of default by the customer is remote.¹⁸

When a customer's note receivable is discounted, the proceeds (cash received) are determined by multiplying the discount rate times the maturity value of the note (face value of the note plus total interest) for the discount period, and deducting the resulting discount from the maturity value. The *discount rate* is the interest rate charged by the bank. It has no relationship to the interest rate charged the customer on the note receivable. The *discount period* is the length of time from the date of discount to the maturity date. Any gain or loss from the discounting is computed by comparing the current book value of the note receivable (including accrued interest revenue) to the proceeds received. The company discounting the note makes journal entries on the date of the discount to record any accrued interest revenue, the proceeds received, and any gain or loss on the discounting of the note. It eliminates the discounted note on the maturity date.

Example: Note Assignment

Assume that on August 31, 2007, the Kasper Corporation discounts (with recourse) a customer's note at its bank at a 14% discount rate. The note was received from the customer on August 1, is for 90 days, has a face value of \$5,000, and carries an interest rate of 12%. The customer pays the note on the October 30, 2007 maturity date. The calculations on August 31 for the discounted note are as follows (assuming a 360-day business year for simplicity):

1. Face value of note	\$5,000.00
2. Interest to maturity ($\$5,000 \times 0.12 \times 90/360$)	150.00
3. Maturity value of note	<u>\$5,150.00</u>
4. Discount ($\$5,150 \times 0.14 \times 60/360$)	<u>(120.17)</u>
5. Proceeds received	\$5,029.83
6. Accrued interest revenue: $\$50$ ($\$5,000 \times 0.12 \times 30/360$)	
7. Book value of note ($\$5,000 + \50)	<u>(5,050.00)</u>
8. Loss from discounting of note	<u>\$ (20.17)</u>

Kasper Corporation makes the following journal entry to record the discounted note on August 31:

Cash	5,029.83	
Loss from Discounting of Note	20.17	
Notes Receivable		5,000.00
Interest Revenue		50.00

When a note is discounted, the difference between the book value of the note and its proceeds is recorded as a gain or loss (as we did in this example) if a company usually does

18. *FASB Statement No. 5, op. cit.*, par. 12.

not discount its notes. Alternatively, if a company normally discounts its notes, the difference is reported as interest revenue or interest expense.

If the Kasper Corporation prepares an interim balance sheet on September 30, 2007, it discloses the contingent liability in the notes to its financial statements. This note might read as follows: “The company is contingently liable for a discounted note receivable of \$5,000. The company does not anticipate that this note will be defaulted on its maturity date.”

In this illustration the contingent liability was eliminated on the maturity date when the customer paid the note. If the customer does not pay this note at maturity, the bank would require Kasper to pay the maturity value of the note plus a service charge on the dishonored note. Kasper’s only recourse is to attempt to collect these amounts from the customer. Consequently, upon default Kasper establishes a Notes Receivable Dishonored account. For example, assume instead that on November 2, 2007, the bank notified Kasper that the note had not been paid and also charged Kasper a \$10 fee. At that time Kasper would record the following journal entry:

Notes Receivable Dishonored	5,160	
Cash [$\$5,000 + (\$5,000 \times 0.12 \times 90/360) + \10]		5,160

If Kasper does not collect the dishonored note in the future, it recognizes a loss on the default. ♦



SECURE YOUR KNOWLEDGE 7-3

- Three basic forms of financing arrangements that allow a company to accelerate the cash flow from its accounts receivable are pledging, assigning, and factoring (sale).
- If a company surrenders control over its receivables, the transaction is recorded as a sale; otherwise, the transaction is considered a secured borrowing (either an assignment with recourse or a pledge as collateral).
- Short-term, interest-bearing notes are recorded at the face value of the note receivable, and interest is recognized by applying a specific interest rate to this face value.
- Non-interest-bearing notes receivable are recorded at their maturity value (which includes both principal and implicit interest), and interest is recognized over the term of the note.
- Similar to accounts receivable, a note receivable may be discounted or transferred to a bank in exchange for cash.

FINANCIAL STATEMENT DISCLOSURES OF RECEIVABLES

Companies are required to disclose any accounting policies related to their receivables that might be helpful to external users. Furthermore, **FASB Statement No. 133** requires a company to *recognize* as assets any derivative financial instruments that involve rights of the company (e.g., a “hedge” of the exposure to changes in the fair value of receivables), based on their fair value. The *Statement* also requires a company to disclose information such as the types of derivative instruments it holds, its objectives in holding the instruments, and its strategies for achieving these objectives. The description must indicate the company’s risk management policy in regard to each type of instrument. **FASB Statement No. 107** requires a company to *disclose* the fair value of all its financial instruments, whether recognized or not on the balance sheet. The *Statement* also requires a company to disclose all significant concentrations of credit risk due to its financial instruments. A company typically makes these disclosures in the notes to its financial statements. The intent of these disclosures is to improve the reporting of a company’s *risk, liquidity, and*



financial flexibility.¹⁹ Real Report 7-3 shows an excerpt from Apple Computer's 2004 year-end balance sheet and related Note 2 illustrating the presentation of receivables.



Real Report 7-3 Disclosure of Accounts Receivable

APPLE COMPUTER, INC.

CONSOLIDATED BALANCE SHEETS

September 25, 2004 and September 27, 2003

	2004	2003
(in millions)		
Current Assets: (in part)		
Accounts receivable, less allowances of \$47 and \$49, respectively	\$774	\$776

Notes to Consolidated Financial Statements (in part)

NOTE 2

Trade Receivables

The following table summarizes the activity in the allowance for doubtful accounts (in millions):

	2004	2003
Beginning allowance balance	\$49	\$51
Charged to costs and expenses	3	4
Deductions (a)	<u>(5)</u>	<u>(6)</u>
Ending allowance balance	<u>\$47</u>	<u>\$49</u>

(a) Represents amounts written off against the allowance, net of recoveries.

Questions:

1. For 2004 recreate the summary journal entries that Apple Computer must have made for its Allowance account.
2. Based on the information presented, comment on the effect of Apple Computer's estimate of bad debt expense on the financial statements for the period presented.

A company includes collections of its accounts receivable and notes receivable from sales in the operating activities section of its statement of cash flows. If a company normally factors its accounts receivable, it generally reports the cash proceeds from the sale in the operation activities section. However, if a company assigns its accounts receivable, the cash proceeds from the loan are reported in the financing section of its statement of cash flows. Collections of interest on notes receivable are included in operating cash flows. However, the receipt by a company of the principal on a note receivable issued for a loan is treated as a cash inflow from an investing activity. When a company discounts a note receivable, the cash received is treated as a cash inflow from a financing activity on its statement of cash flows.

APPENDIX: INTERNAL CONTROLS FOR CASH

Two important elements of internal control over cash are a petty cash fund and a bank reconciliation. We discuss each of these elements in the following sections.

19. "Accounting for Derivative Instruments and Hedging Activities," *FASB Statement of Financial Accounting Standards No. 133* (Norwalk, Conn.: FASB, 1998), par. 17 and 44; and "Disclosures about Fair Value of Financial Instruments," *FASB Statement of Financial Accounting Standards No. 107* (Norwalk, Conn.: FASB, 1991), par. 7 and 15A.

PETTY CASH

A petty cash system involves a cash fund under the control of an employee that enables a company to pay for small amounts that might be impractical or impossible to pay by check. For example, a company requiring employees to work overtime may have a policy of sending late-working employees home by taxi. Since taxi drivers do not usually accept checks, the company may give these employees cash to pay the taxi fare. Small amounts of cash may also be needed to pay for postage, deliveries, the purchase of small amounts of office supplies, and other items. A company may use a petty cash system for these purposes. The design and operation of a petty cash system includes the following steps:

10 Understand a petty cash fund.

1. An employee is appointed petty cash custodian. The petty cash fund is established at an amount estimated to be enough to cover expenditures over a short period of time, and the fund is turned over to the employee. The journal entry to record the establishment of the fund is a debit to Petty Cash and a credit to Cash for \$500 (amount assumed).
2. Petty cash vouchers are printed, prenumbered, and given to the custodian of the fund. The vouchers are used as evidence of expenditures. Therefore at all times the total of the cash in the fund plus the amounts of expenditure vouchers should be equal to the original amount of the fund, in this case \$500. The custodian completes a petty cash voucher each time a payment from the fund is made, but journal entries are *not* recorded at this time.
3. When the amount of cash in the petty cash fund becomes low and/or at the end of an accounting period, the vouchers are sorted into expense categories and the remaining cash is counted. The expenses are then recorded and the fund is replenished. At this time, a Cash Short and Over account is used to record any “shortage” or “overage” between the original petty cash fund balance and the remaining cash in the fund plus the amounts of the petty cash vouchers. The account helps to highlight errors and improve internal control. For example, assume that a count at the end of the month shows \$67.54 remaining in the petty cash fund, and the sorting of vouchers indicates the following costs were incurred during the month:

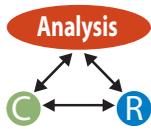
Office supplies	\$ 34.16
Postage	178.00
Transportation	132.14
Miscellaneous	<u>83.76</u>
Total expenses	<u>\$428.06</u>

Since these expenses total \$428.06 and the amount needed to replenish the fund is \$432.46 (\$500 – \$67.54), the fund is “short” by \$4.40. The company records (debits) the actual expenses (along with Cash Short and Over), rather than petty cash, as follows when it replenishes the fund:

Office Supplies Expense	34.16	
Postage Expense	178.00	
Transportation Expense	132.14	
Miscellaneous Expense	83.76	
Cash Short and Over	4.40	
Cash		432.46

The \$432.46 is given to the fund custodian, and the actual amount of cash in the petty cash fund is now equal to the original fund balance of \$500. The company reports the expenses on its income statement. It reports a debit balance in the Cash Short and Over account at the end of the accounting period as a miscellaneous expense; it reports a credit balance as a miscellaneous revenue. The company includes the balance of the petty cash fund as part of the Cash amount reported on its balance sheet when it issues financial statements.

BANK RECONCILIATION



The information in a company's Cash account is also kept by an external independent party, the company's bank. Therefore it is a good internal control procedure to use one to verify the other. A bank reconciliation is a schedule that a company prepares to analyze the difference between the ending cash balance in its accounting records and the ending cash balance reported by its bank in a bank statement to determine the correct ending cash balance.

Banks send a monthly statement to each depositor summarizing the activities that have taken place in the depositor's account. These activities include deposits, checks cleared, miscellaneous items, and the ending balance in the checking account. Also included with the bank statement may be photos of the depositor's canceled checks. Every company has a checking account and keeps its own accounting records of its deposits and checks. The bank statement and the company's accounting records usually will not be in complete agreement. When the company receives the bank statement each month, it prepares a bank reconciliation to compare the bank statement balance and its cash balance to reconcile these records.



Credits: Getty Images/PhotoDisc (both images)



Causes of the Difference

The causes of the difference between the cash balance listed on a company's bank statement and the balance shown in the company's cash account include the following items:

1. **Outstanding Checks.** An outstanding check is a check written by the company and deducted from its cash balance that the bank has not yet deducted from the balance reported on the bank statement. On the date a company issues a check, it reduces its Cash account. A period of time is necessary for the check to be received by the payee (the recipient of the check), deposited in the payee's bank, and subtracted from the company's bank balance. Therefore a company has a certain number of outstanding checks at the end of each month that causes its Cash account balance to be less than the balance on the bank statement.
2. **Deposits in Transit.** A deposit in transit is a cash receipt added to the company's cash balance but not yet added to the balance reported on the bank statement. When a company receives a check, it increases its Cash account. A period of time may pass before the check is deposited by the company and recorded by the bank. At the end of each month the company may have deposits in transit (either cash or checks) that cause its Cash account balance to be greater than the balance on the bank statement.
3. **Charges Made Directly by the Bank.** A bank frequently imposes a service charge for a depositor's checking account and deducts this charge directly from the account.

Banks also charge for the cost of printing checks and for stopping payment on checks. The bank reports these charges on the bank statement.

When the company receives a customer's check, it deposits the check in its bank as a cash receipt even though the customer's bank has not yet transferred the cash from the customer's bank account to the company's bank account. Occasionally, the company's bank is unable to collect the amount of the customer's check. That is, the customer's check has "bounced." **NSF (not sufficient funds) is the term used for a customer's check that a company has deposited in its bank account but has not been paid by the customer's bank because there is not enough cash in the customer's account.** Because the bank has not received payment from the customer, it deducts this amount from the company's bank account. Consequently, there may be some NSF checks included in the bank statement that the company has not recorded.

At the end of the month the bank lists all of these charges as deductions from the company's cash balance on the bank statement even though the company may not have deducted them from its cash balance in its accounting records. Therefore the bank statement balance is less than the balance in the company's Cash account.

4. **Deposits Made Directly by the Bank.** A bank often acts as a collection agency for its customers on items such as notes receivable. In addition, most checking accounts earn interest. When the bank collects a note, it records the amount (principal and interest) as an increase in the company's bank account. Consequently, the bank statement may include notes received by the bank that the company has not yet recorded in its accounting records. The company may not know the amount of interest it has earned on its checking account until it receives the bank statement. In both these situations the bank statement balance is greater than the balance in the company's Cash account.
5. **Errors.** Despite the internal control procedures established by the bank and the company, the company may discover errors in either the bank's records or its records when it prepares the bank reconciliation. For example, a bank may include a deposit or a check from another customer's account or make an error in recording an amount. A company may similarly make an error in recording an amount. For example, a common error is to transpose two numbers, so that the correct amount of \$426 is recorded as \$462.

Procedures for Preparing a Bank Reconciliation

Given the items that might cause a difference between the ending balance in a company's Cash account and the ending cash balance from the bank statement, the company should follow a list of procedures in preparing its bank reconciliation:

1. **Compare the deposits listed in the company's records with the deposits shown on the bank statement.** Determine that the deposits in transit included in the *last* month's bank reconciliation are listed in this month's bank statement. These deposits do not need any adjustment in the bank reconciliation. If they are *not* shown on the bank statement, immediately investigate to determine if an error or theft has occurred. Identify any deposits for the current month that are not listed on the bank statement. Add the amounts of all the deposits in transit to the ending cash balance of the bank statement in the reconciliation.
2. **Compare the checks listed in the company's records with the checks shown on the bank statement.** Determine that the outstanding checks included in last month's bank reconciliation are listed in this month's bank statement. These checks do not need any adjustment in the bank reconciliation. If they are *not* shown on the bank statement, investigate to determine if the checks were received by the creditors so that the company's "credit rating" is not affected. Identify any checks for the current month not deducted in the bank statement. Subtract the amounts of all the outstanding checks from the ending cash balance of the bank statement in the reconciliation.

11 Prepare a bank reconciliation.

3. **Identify any deposits or charges made directly by the bank that are not included in the company's records.** These items include collections of notes receivable, interest earned on the checking account, service charges, NSF checks, and so on, which are listed on the bank statement. Add the collections to or subtract the charges from the company's ending cash balance in the bank reconciliation.
4. **Determine the effect of any errors.** If an error is found, the nature of the error determines whether to add the error to or subtract the error from the company's ending cash balance or from the ending cash balance of the bank statement.
5. **Complete the bank reconciliation.** Use the format we discuss below.

A company is required to report on its balance sheet the amount of cash over which it has control at the end of an accounting period. Our discussion focuses on the form of reconciliation that arrives at an *adjusted*, or *corrected*, cash balance, indicating the amount of cash that a company reports on its balance sheet. We illustrate this form of bank reconciliation as follows (using assumed amounts):



Cash balance from bank statement		\$7,218
Add: Receipts recorded on the company's records but not reported on the bank statement. <i>Examples:</i> deposits in transit and cash received and recorded but not yet deposited		629
		\$7,847
Deduct: Payments recorded on the company's records but not reported on the bank statement. <i>Example:</i> outstanding checks		(516)
Adjusted Cash Balance		\$7,331
Cash balance from company records		\$6,925
Add: Receipts reported on the bank statement but not recorded on the company's records. <i>Examples:</i> notes receivable and interest collected by the bank or interest earned on the funds on deposit		715
		\$7,640
Deduct: Payments reported on the bank statement but not recorded on the company's records. <i>Examples:</i> bank service charge and customers' checks returned for lack of funds (NSF checks)		(309)
Adjusted Cash Balance		\$7,331

After the company completes the bank reconciliation, it makes journal entries to bring its accounts up to date. The company only makes journal entries for the adjustments it made to its records on the bank reconciliation. It does *not* make journal entries for the adjustments it made to the bank statement balance on the reconciliation; the bank will record these adjustments in its accounts at the appropriate time.

Example: Bank Reconciliation

The following example shows the preparation of a bank reconciliation and the required adjusting entries for the Craig Corporation for the month ended June 30, 2007. The unadjusted cash balances are as follows:

Cash balance from bank statement, June 30	\$12,461.15
Cash balance from company records, June 30	12,437.94

The bank statement disclosed the following information:

1. A customer note for \$1,200 plus \$12 interest was collected on June 29.
2. A customer check for \$138.14 was returned because of insufficient funds (NSF check).
3. The monthly service charge was \$15.

A review of the company records disclosed the following:

1. A deposit for \$1,142.87 at the end of the day on June 30 did not appear on the bank statement.
2. Customer checks totaling \$327.40 were on hand at the end of June awaiting deposit.
3. The following company checks were outstanding at the end of June:

#862	\$ 96.19
#864	147.18
#865	263.25
4. Check #843, written for \$91.20 in payment of an account payable and included with the canceled checks in the bank statement, was erroneously recorded as \$19.20 in the company's records.

The upper part of Example 7-4 shows the preparation of a bank reconciliation based on this information. After completing the reconciliation, the Craig Corporation prepares adjusting entries to record those items not previously included in its accounts. We show these entries in the bottom part of Example 7-4 (with arrows to indicate which items are adjusted). These adjusting entries adjust the Cash account to \$13,424.80, the amount that Craig Corporation reports as its cash balance (along with any petty cash) on its June 30, 2007 balance sheet. ♦

EXAMPLE 7-4 Bank Reconciliation and Adjusting Entries

Craig Corporation Bank Reconciliation June 30, 2007

Cash balance from bank statement			\$12,461.15
Add:	Deposit in transit	\$1,142.87	
	Checks on hand	<u>327.40</u>	<u>1,470.27</u>
			\$13,931.42
Deduct:	Outstanding checks:		
	#862	\$ 96.19	
	#864	147.18	
	#865	<u>263.25</u>	<u>(506.62)</u>
Adjusted Cash Balance			<u><u>\$13,424.80</u></u>

Cash balance from company records			\$12,437.94
Add:	Note collected by bank	\$1,200.00	
	Interest on note	<u>12.00</u>	<u>1,212.00</u>
			\$13,649.94
Deduct:	Bank service charge	\$ 15.00	
	NSF check returned	138.14	
	Error in recording check #843	<u>72.00</u>	<u>(225.14)</u>
Adjusted Cash Balance			<u><u>\$13,424.80</u></u>

Adjusting Entries

June 30	Cash	1,212.00	
	Notes Receivable (note collected)		1,200.00
	Interest Revenue (interest collected)		12.00
30	Miscellaneous Expense		
	(bank service charge)	15.00	
	Accounts Receivable (NSF check)	138.14	
	Accounts Payable (error)	72.00	
	Cash		<u>225.14</u>

SUMMARY

At the beginning of the chapter, we identified several objectives you would accomplish after reading the chapter. The objectives are listed below, each followed by a brief summary of the key points in the chapter discussion.

- 1. Identify items of cash (and cash equivalents).** Cash consists of coins and currency, unrestricted funds on deposit with a bank (checking and savings accounts), negotiable checks, and bank drafts. Cash equivalents are short-term, highly liquid investments (having maturity dates of three months or less from the date acquired) that are readily convertible into known amounts of cash.
- 2. Understand the importance of cash management.** Cash management is important so that a company has enough cash available to pay its bills, but does not have idle cash as a nonproductive resource. To do so, a company must have sound cash planning systems (cash budget) and sound cash control systems (internal control).
- 3. Discuss revenue recognition when the right of return exists.** When the right of return exists, a company recognizes revenue at the time of the sale only when six conditions are met. Briefly, these are: (1) the sales price is known, (2) the buyer has paid or will pay, (3) the buyer's obligation is not affected by theft or damage, (4) the buyer is a separate entity from the seller, (5) the seller does not have to help resell the product, and (6) the seller can estimate the future returns.
- 4. Understand the credit policies and internal control related to accounts receivable.** A company sells on credit to increase sales. Credit policies should be closely associated with customers' credit ratings. A company should adopt a credit policy that combines increased customer satisfaction with increased sales revenue, credit department costs, and bad debt losses in a way that results in the highest incremental profit and cash flows. A company should use prenumbered invoices and separate the sales function from the collection function to help maintain internal control over accounts receivable.
- 5. Explain the gross and net methods to account for cash discounts.** Under the gross method, a company records accounts receivable and sales at the gross price. If the customer takes the cash discount, the company debits Sales Discounts Taken for the amount of the discount. Under the net method, a company records accounts receivable and sales at the net price. If the customer does not take the cash discount, the company credits Sales Discount Not Taken for the amount of the lost discount.
- 6. Estimate and record bad debts using a percentage of sales.** Under the percentage of sales method, a company debits the bad debts expense account and credits the allowance account for an amount based on an estimate of the percentage of the current sales that will not be collected.
- 7. Estimate and record bad debts using an aging analysis.** Under the aging method, a company first classifies its accounts receivable into categories based on their age. Then it multiplies the amount in each category by the percentage estimated to be uncollectible, and sums the expected uncollectible amounts. Finally, it deducts this sum from the balance in the allowance account to determine the amount to record as a debit to bad debts expense and a credit to the allowance account.
- 8. Explain pledging, assignment, and factoring of accounts receivable.** When a company *pledges* accounts receivable, it uses these accounts as collateral for a loan. When a company *assigns* accounts receivable, it enters into a lending agreement with a financial institution to receive cash on specific customer accounts. When a company *factors* accounts receivable, it sells individual accounts to a financial institution.
- 9. Account for short-term notes receivable.** When a company receives an interest-bearing note receivable, it records the note at its face value. It then records interest revenue when it collects the note. When a company receives a non-interest-bearing note, it records the note at its maturity value and, for simplicity, also records interest revenue at this time.
- 10. Understanding a petty cash fund (Appendix).** A petty cash system involves assigning a cash fund to an employee who has control over the fund, and who pays for small amounts (e.g., postage) that might be impractical or impossible to pay by check. At all times the amount of the cash in the fund plus the amount of expenditure vouchers should be equal to the original amount in the fund.
- 11. Prepare a bank reconciliation (Appendix).** To prepare a bank reconciliation, add the amounts of any deposits in transit to, and subtract the amounts of any outstanding checks from, the ending bank statement balance. Next, add any collections or subtract any charges made directly by the bank to or from the company's ending cash balance. Then adjust the ending bank statement balance or company's ending cash balance for any errors, and complete the bank reconciliation.

ANSWERS TO REAL REPORT QUESTIONS

Real Report 7-1 Answers

- Cash and cash equivalents are reported as one combined amount because the investment is readily convertible into cash (three months or less at the date of purchase), and the risk that the short-term investment's value will change significantly due to a change in interest rates is minimal.

Real Report 7-2 Answers

1. In a factoring arrangement, the receivables are sold, without recourse, to the factor. Because the factor assumes all risks of ownership and cannot demand payment from UNIFI for any uncollectible accounts, no allowance for uncollectible accounts is needed. The factor is assuming all losses from uncollectible accounts.
2. The factors will charge UNIFI a commission which is usually based on the amount of the receivables transferred. Additionally, UNIFI will incur costs related to notifying its customers that their receivables have been factored. Apparently, UNIFI believes it will be cheaper to collect the receivables itself rather than incur the costs associated with the factoring arrangement.

Real Report 7-3 Answers

1. The appropriate journal entries (dollars in millions) would be:

Bad Debt Expense	3	
Allowance for Doubtful Accounts		3
Allowance for Doubtful Accounts	5	
Accounts Receivable		5
2. Assuming that delinquent accounts receivable are written off relatively quickly (e.g., when they are six months overdue), Apple appears to be underestimating bad debt expense since write-offs exceed the expense by approximately \$2 million. This underestimate of expense would have the effect of increasing Apple Computer's reported income.

QUESTIONS

Q7-1 What are the components of cash? What items may be confused with cash, but normally are categorized under other balance sheet captions? What are "cash equivalents"?

Q7-2 What is internal control?

Q7-3 What are the two revenue recognition criteria and how do they relate to receivables in some industries?

Q7-4 Briefly discuss the two methods of recording accounts receivable when cash discounts are involved.

Q7-5 What is a sales return? A sales allowance? Conceptually, when should sales returns and allowances be recorded?

Q7-6 Discuss the differences between the estimation (allowance) methods of recording bad debts and the direct write-off method.

Q7-7 Explain how a company estimates bad debts using (a) the sales or income statement approach, and (b) the accounts receivable or balance sheet approach.

Q7-8 Define the *net realizable value* of a company's accounts receivable. How is the net realizable value of accounts receivable reported on the company's balance sheet?

Q7-9 What method of bad debt estimation categorizes individual accounts receivable based on the length of time outstanding? Why is this length of time an important factor?

Q7-10 Why does the write-off of uncollectible accounts have no effect on the net realizable accounts receivable on the balance sheet if bad debts are estimated? What is the effect of this write-off on the income statement?

Q7-11 Define pledging, assigning, and factoring of accounts receivable.

Q7-12 When does a company record the transfer of accounts receivable as a sale? As a liability?

Q7-13 What is a note receivable? How do notes receivable differ from accounts receivable?

Q7-14 What is a non-interest-bearing note? How does accounting for a short-term non-interest-bearing note differ from a short-term interest-bearing note?

Q7-15 What are notes receivable discounted? How are discounted notes disclosed on the financial statements during the period between the discount date and maturity date?

Q7-16 How are the cash proceeds determined when a note receivable is discounted?

Q7-17 (Appendix) What is the purpose of a petty cash system?

Q7-18 (Appendix) Why are actual expenses, rather than the petty cash account, debited when the fund is replenished?

Q7-19 (Appendix) What is a bank reconciliation? List the causes of the difference between the cash balance listed on a company's bank statement and the balance shown in the company's cash account.

Q7-20 (Appendix) Why are adjusting entries made after the bank reconciliation is completed? Give an example of an item on a bank reconciliation which requires an adjusting entry.

MULTIPLE CHOICE (AICPA Adapted)

Select the best answer for each of the following.

M7-1 Which of the following items should be classified under the heading of cash on the balance sheet?

	Postdated checks	Certificates of deposit
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M7-2 Greenfield Company had the following cash balances at December 31, 2007:

Cash in banks	\$1,500,000
Petty cash funds (all funds were reimbursed on December 31, 2007)	20,000
Cash legally restricted for additions to plant (expected to be disbursed in 2009)	2,000,000

Cash in banks includes \$500,000 of compensating balances against short-term borrowing arrangements at December 31, 2007. The compensating balances are not legally restricted as to withdrawal by Greenfield. In the current assets section of Greenfield's December 31, 2007 balance sheet, what total amount should be reported as cash?

- a. \$1,020,000 c. \$3,020,000
b. \$1,520,000 d. \$3,520,000

M7-3 On January 1, 2007, King Company's Allowance for Doubtful Accounts had a credit balance of \$15,000. During 2007 King, (1) charged \$32,000 to bad debt expense, (2) wrote off \$23,000 of uncollectible accounts receivable, and (3) unexpectedly recovered \$6,000 of bad debts written off in the prior year. The Allowance for Doubtful Accounts balance at December 31, 2007 should be:

- a. \$47,000 c. \$30,000
b. \$32,000 d. \$24,000

M7-4 A company is in its first year of operations and has never written off any accounts receivable as uncollectible. When the allowance method of recognizing bad debt expense is used, the entry to recognize that expense

- a. Increases net income
b. Decreases current assets
c. Has no effect on current assets
d. Has no effect on net income

M7-5 Tallent Company received a \$30,000, 6-month, 10% interest-bearing note from a customer. After holding the note for two months, Tallent was in need of cash and discounted the note at the United National Bank at a 12% discount rate. The amount of cash received by Tallent from the bank was

- a. \$31,260 c. \$30,300
b. \$30,870 d. \$30,240

M7-6 When the accounts receivable of a company are sold outright to a company that normally buys accounts receivable of other companies without recourse, the accounts receivable have been

- a. Factored c. Pledged
b. Assigned d. Collateralized

M7-7 A method of estimating bad debts that focuses on the income statement rather than the balance sheet is the allowance method based on

- a. Direct write-off
b. Aging the trade receivable accounts
c. Credit sales
d. The balance in the trade receivable accounts

M7-8 Prior to adjustments, Barrett Company's account balances at December 31, 2007 for Accounts Receivable and the related Allowance for Doubtful Accounts were \$1,200,000 and \$60,000, respectively. An aging of accounts receivable indicated that \$106,000 of the December 31, 2007 receivables may be uncollectible. The net realizable value of accounts receivable was

- a. \$1,034,000 c. \$1,140,000
b. \$1,094,000 d. \$1,154,000

M7-9 Marmol Corporation uses the allowance method for bad debts. During 2007 Marmol charged \$30,000 to bad debt expense and wrote off \$25,200 of uncollectible accounts receivable. These transactions resulted in a decrease in working capital of

- a. \$0 c. \$25,200
b. \$4,800 d. \$30,000

M7-10 The following bank reconciliation is presented for the Kingston Company for the month of November 2007:

Balance per bank statement, 11/30/07	\$18,040
Add: Deposit in transit	4,150
	\$22,190
Less: Outstanding checks	\$ 6,300
Bank credit recorded in error	20
Balance per books, 11/30/07	\$15,870

Data for the month of December 2007 follow:

Per bank	
December deposits	\$26,100
December disbursements	22,420
Balance, 12/31/07	21,720

All items that were outstanding as of November 30 cleared through the bank in December, including the bank credit. In addition, \$2,500 in checks were outstanding as of December 31, 2007. What is the balance of cash per books at December 31, 2007?

- a. \$19,220 c. \$21,720
b. \$19,240 d. \$24,220

EXERCISES

E7-1 *Computing the Cash Balance* Indicate whether or not each of the following ten items should be included in the cash balance presented on the balance sheet. Also indicate the normal balance sheet treatment for those items not included as cash.

Item	Include in Cash Balance	Classification of Items Excluded
1. NSF checks	_____	_____
2. Savings account	_____	_____
3. Postage stamps	_____	_____
4. Postdated checks	_____	_____
5. IOUs	_____	_____
6. Cash on hand	_____	_____
7. Cash in sinking fund	_____	_____
8. Travel advance	_____	_____
9. Bank draft	_____	_____
10. Traveler's checks	_____	_____

E7-2 *Reporting Cash on the Balance Sheet* Your audit of the Watt Corporation discovers the following information:

1. Reconciled balance in First National Bank checking account	\$ 2,360.75
2. Reconciled balance in City National Bank checking account	(40.20)
3. Balance in First Federal savings account	28,750.00
4. Certificate of deposit	30,000.00
5. Postage stamps	100.00
6. Employee's IOU	125.00
7. Employees' travel advances	1,640.00
8. Cash on hand (undeposited sales receipts)	3,609.40
9. Traveler's checks	600.00
10. Customer's postdated check	290.40

Required

1. What amount should be reported as cash on Watt's balance sheet?
2. Describe the balance sheet treatment of the items not included in the cash balance.

E7-3 *Journal Entry to Separate Receivables* An examination of the accounting records for the Hutton Corporation indicates that all receivables are being recorded in a single account entitled Receivables. An analysis of the account reveals the following:

Accounts receivable (trade)	\$15,500
Accounts receivable (officers)	3,600
Common stock subscriptions receivable (current)	12,000
Advances to employees	1,800
Notes receivable (trade), due in 3 years	6,000
Deposit to guarantee contract performance	5,000
Utility deposit	500
Total	<u>\$44,400</u>

Required

1. Prepare a journal entry to separate the preceding items into their proper accounts.
2. How would each of the preceding items normally be reflected on Hutton's balance sheet?

E7-4 *Accounting for Sales Discounts* On December 8, 2007, Lynch Incorporated sold \$9,000 of merchandise with terms 2/10, n/EOM. On December 18, 2007, collections were made on sales originally billed for \$5,000, and on December 31, 2007, additional collections on sales originally billed for \$3,000 were received.

Required

Prepare the journal entries to record the sale, collections, and any required year-end adjustments under (1) the gross price method, and (2) the net price method.

E7-5 Comparison of Discount Methods The Eastman Corporation sells merchandise with a list price of \$13,000 on February 1, 2007, with terms of 1/10, n/30. On February 10, 2007, payment was received on merchandise originally billed for \$7,500, and the balance due was received on February 28, 2007.

Required

Prepare journal entries to record the preceding information using (1) the gross price method, and (2) the net price method.

E7-6 Returns and Allowances Towbin Products sells merchandise on credit for \$7,000 on December 1, 2007. The company estimates that returns and allowances will amount to 4% of sales. On December 22, 2007, a customer returns for credit merchandise originally sold on December 1 for \$200.

Required

1. Prepare journal entries to record the preceding sale and the return of merchandise if returns are recorded as they occur.
2. Prepare journal entries to record the preceding sale, the estimation of returns and allowances, and the actual return of goods, if returns and allowances are estimated at the end of the period of sale.
3. How would the preceding information be reflected on Towbin's December 31, 2007 financial statements if (a) returns are recorded as they occur, and (b) returns are estimated in the period of sale?

E7-7 Estimation vs. Direct Write-Off of Bad Debts The Blunt Company makes credit sales of \$21,000 during the month of February 2007. During 2007 collections are received on February sales of \$20,400, accounts representing \$600 of these sales are written off as uncollectible, and a \$100 account previously written off is collected.

Required

Prepare the journal entries necessary to record the preceding information if (1) bad debts are estimated as 3% of sales at the time of sale, and (2) the bad debts are recorded as they actually occur.

E7-8 Estimating Bad Debts from Receivables Balances The following information is extracted from the accounting records of the Shelton Corporation at the beginning of 2007:

Accounts Receivable	\$63,000
Allowance for Doubtful Accounts	1,400 (credit)

During 2007, sales on credit amounted to \$575,000, \$557,400 was collected on outstanding receivables, and \$2,600 of receivables were written off as uncollectible. On December 31, 2007, Shelton estimates its bad debts to be 4% of the outstanding gross accounts receivable balance.

Required

1. Prepare the journal entry necessary to record Shelton's estimate of bad debt expense for 2007.
2. Prepare the Accounts Receivable section of Shelton's December 31, 2007 balance sheet.
3. Compute Shelton's receivables turnover.

E7-9 Aging Analysis of Accounts Receivable Cowen's, a large department store located in a metropolitan area, has been experiencing difficulty in estimating its bad debts. The company has decided to prepare an aging schedule for its outstanding accounts receivable and estimate bad debts by the due dates of its receivables. This analysis discloses the following information:

Balance	Age of Receivable	Estimated Percentage Uncollectible
\$193,000	Under 30 days	0.8%
114,000	30–60 days	2.0%
73,000	61–120 days	5.0%
41,000	121–240 days	20.0%
25,000	241–360 days	35.0%
19,000	Over 360 days	60.0%
<u>\$465,000</u>		

Required 

1. Use the preceding analysis to compute the estimated amount of uncollectible receivables.
2. Prepare the journal entry to record Cowen's estimated uncollectibles, assuming the balance in the Allowance for Doubtful Accounts prior to adjustment is:
 - a. 0
 - b. \$3,000 (debit)
 - c. \$2,800 (credit)

E7-10 Comparison of Bad Debt Estimation Methods The following information (prior to adjustment) is available from the accounting records of the Bradford Company on December 31, 2007:

Cash sales	\$ 93,100	
Net credit sales	<u>262,900</u>	
Total sales (net)		\$356,000
Accounts receivable		126,300
Allowance for doubtful accounts		2,150 (credit)

Required

Prepare journal entries to record the estimate of Bradford's bad debt expense for 2007 assuming:

1. Bad debts are estimated to be 1.5% of total sales (net).
2. Bad debts are estimated to be 2% of net credit sales.
3. Bad debts are estimated to be 5% of gross accounts receivable.

E7-11 AICPA Adapted Receivables—Bad Debts At January 1, 2007 the credit balance in the Allowance for Doubtful Accounts of the Master Company was \$400,000. For 2007 the provision for doubtful accounts is based on a percentage of net sales. Net sales for 2007 were \$50,000,000. Based on the latest available facts, the 2007 provision for doubtful accounts is estimated to be 0.7% of net sales. During 2007 uncollectible receivables amounting to \$410,000 were written off against the allowance for doubtful accounts.

Required 

Prepare a schedule computing the balance in Master's Allowance for Doubtful Accounts at December 31, 2007. Show supporting computations in good form.

E7-12 Assigning Accounts Receivable White Corporation has entered into a long-term assignment agreement with a finance company. Under the terms of this agreement, White receives 80% of the value of all accounts assigned and is charged a 1% service charge which is based upon the actual dollar amount of cash received. Additionally, the finance company charges White 12% annual interest on the outstanding loan. The following selected transactions relate to this agreement:

December 1, 2007	Accounts receivable of \$160,000 are assigned.
December 11, 2007	A sales return of \$1,000 on an assigned account is allowed by White.
December 31, 2007	Collections are made on \$86,000 of assigned accounts. This amount and 1 month's interest on the outstanding loan are remitted to the finance company. (For simplicity, compute interest to the nearest month.)
January 29, 2008	\$50,000 of assigned accounts are collected and the remainder of the loan is repaid.

Required

1. Prepare journal entries on White's books to record the preceding transactions.
2. How would this assignment agreement be reported on White's December 31, 2007 balance sheet (assume the note payable is short-term)?

E7-13 Factoring Accounts Receivable The Inder Corporation is experiencing a temporary cash shortage and decides to factor a group of its accounts receivable. The factor accepts \$80,000 of Inder's accounts receivable, remits 90% of the accounts receivable factored, and charges a 16% commission on the gross amount of the factored receivables. During the period, sales returns and allowances on factored accounts amounted to \$1,500.

Required

Prepare all the journal entries necessary by Inder to record the preceding information.

E7-14 AICPA Adapted Generating Cash from Receivables The Guide Company requires additional cash for its business. Guide has decided to use its accounts receivable to raise the additional cash as follows:

1. On June 30, 2007, Guide assigned \$200,000 of accounts receivable to the Cell Finance Company. Guide received an advance from Cell of 85% of the assigned accounts receivable, less a commission on the advance of 3%. Prior to December 31, 2007, Guide collected \$150,000 on the assigned accounts receivable and remitted \$160,000 to Cell, \$10,000 of which represented interest on the advance from Cell.
2. On December 1, 2007, Guide sold \$300,000 of net accounts receivable to the Factoring Company for \$260,000. The receivables were sold outright on a nonrecourse basis.
3. On December 29, 2007, Guide received an advance of \$100,000 from the Domestic Bank by pledging \$120,000 of Guide's accounts receivable. Guide's first payment to Domestic is due on January 29, 2008.

Required

Prepare a schedule showing the income statement effect for the year ended December 31, 2007, as a result of the preceding facts. Show supporting computations in good form.

E7-15 Interest-Bearing and Non-Interest-Bearing Notes On December 11, 2007, the Hooper Bank loans a customer \$12,000 on a 60-day, 12% note.

Required

Prepare the journal entries necessary to record the receipt of the note by Hooper, the accrual of interest on December 31, 2007, and the customer's repayment on February 9, 2008, assuming:

1. Interest was assessed in addition to the face value of the note.
2. The note was issued as a \$12,000 non-interest-bearing note.

E7-16 Computing the Proceeds from Discounted Notes Below are several customer notes.

1. An \$8,000, 60-day, non-interest-bearing note discounted after 15 days at 12%.
2. A \$9,000, 12%, 60-day note discounted after 30 days at 14%.
3. A \$6,000, 10%, 90-day note discounted after 30 days at 12%.
4. A \$10,000, 12%, 120-day note discounted after 45 days at 15%.

Required 

Determine the proceeds from each of the preceding discounted customer notes.

E7-17 Recording Notes Receivable Discounted The following are events of the Singer Corporation for the current year:

June 30	Barney Manufacturing gives Singer a \$5,000, 11%, 90-day note for merchandise purchased.
July 15	Dillon Construction Co. gives Singer a \$6,000, 10%, 60-day note for merchandise originally purchased on April 20 of the current year.
July 30	The Barney and Dillon notes are discounted with recourse by Singer at its bank at 12%.
Sept. 15	The bank notifies Singer that the Dillon note was paid.
Sept. 30	The bank notifies Singer that Barney defaulted on the note and charges the amount of principal, interest, and a fee of \$10 against Singer's bank account.

Required

Prepare journal entries to record the preceding information on Singer's accounting records. (Assume that the company does not normally discount its notes.)

E7-18 Petty Cash Transactions (Appendix) The Crown Company established a petty cash fund of \$600 for incidental expenditures on January 2, 2007. At the end of the month the count of cash on hand indicated that \$57.35 remained in the fund. A sorting of petty cash vouchers disclosed that the following expenses had been incurred during the month, and the fund was replenished.

Postage expense	\$250.40
Office supplies expense	165.90
Miscellaneous expense	119.05

Required

Prepare the journal entries necessary to record the Crown Company's petty cash transactions during the month of January 2007.

E7-19 Adjusting an Unknown Cash Balance (Appendix) The information that follows is available from the general ledger and the bank statement of the Gentry Corporation for the month of August 2007:

1. Bank statement balance, August 31	\$1,342.50
2. Note collected by the bank not previously recorded by Gentry	600.00
3. Interest on the preceding note (not previously recorded)	25.00
4. NSF check returned with the bank statement (not previously recorded)	212.60
5. Outstanding checks at the end of August	684.70
6. Bank service charge for August	12.85
7. Deposit in transit, August 31	329.42

Required

1. Starting with the bank statement balance, prepare a schedule to determine Gentry's cash balance on August 31, 2007, prior to any required adjustments.
2. Prepare a bank reconciliation to determine Gentry's adjusted cash balance on August 31, 2007.
3. Prepare the journal entries necessary to bring Gentry's cash account balance up to date.

E7-20 Bank Reconciliation (Appendix) The following information is extracted from the bank statement and the accounting records of the Sun Corporation for the month of July 2007:

1. Cash balance from books, July 31	\$1,967.35
2. Cash balance from bank, July 31	1,980.20
3. NSF check returned by bank with bank statement	81.00
4. Note collected by bank on July 31	190.00
5. Interest on preceding note	5.50
6. Bank service charge for July	4.40
7. Outstanding checks at end of July	150.00
8. Deposit in transit at end of July	247.25

Required

1. Prepare a bank reconciliation for the Sun Corporation for July 31, 2007.
2. Prepare the journal entries necessary to adjust Sun's books on July 31, 2007.

E7-21 Bank Reconciliation and Adjusting Entries (Appendix) The Odum Corporation's cash account showed a balance of \$17,198 on March 31, 2007. The bank statement balance for the same date indicated a balance of \$17,924.55. The following additional information is available concerning Odum's cash balance on March 31, 2007.

1. Undeposited cash on hand on March 31 amounted to \$724.50.
2. A customer's NSF check for \$173.80 was returned with the bank statement.
3. A note for \$2,000 plus interest of \$25 was collected for Odum by the bank during March. The bank notified Odum of this collection on the bank statement.
4. The bank service charge for March was \$15.
5. A deposit of \$951.75 mailed to the bank on March 31 did not appear on the bank statement.
6. The following checks mailed to creditors had not been processed by the bank on March 31:

#429	\$ 57.40	#433	\$214.80
#432	\$147.50	#434	\$191.90
7. A customer check for \$149.50 in payment of his account and listed correctly for that amount on the bank statement had been incorrectly recorded on the accounting records as \$194.50.

Required 

1. Prepare a bank reconciliation for the Odum Corporation for March 31, 2007.
2. Prepare any adjusting journal entries necessary to record the information from Requirement 1.

E7-22 Computing the Bank Statement Balance (Appendix) Your cashier I. Amakrook has notified you that he has misplaced all the bank statements for the past year. You decide to review selected accounting records during the year and discover that the following journal entry was made to reconcile the June 30, 2007 bank statement and the accounting records:

Accounts Receivable	1,520.24	
Miscellaneous Expense	12.50	
Notes Receivable		200.00
Interest Revenue		10.00
Cash		1,322.74

Required

1. What events might have caused each of the preceding reconciling items to occur?
2. Compute the amount that would have appeared as the balance per bank statement on a bank reconciliation if the preadjustment cash balance in the accounting records was \$7,683.70, outstanding checks were \$207.50, and no other adjustments were required.
3. Assume that you contact the bank and are informed that a balance of \$5,542.90 had been reported on the June 30, 2007 bank statement. What does this discrepancy indicate and how would you begin investigating it?

PROBLEMS

P7-1 Cash and Other Items The following information has been extracted from the accounting records of the Atwood Corporation:

1. Cash on hand (undeposited sales receipts) \$ 1,020

2. Certificates of deposit	25,000
3. Customer's note receivable	1,000
4. Reconciled balance in University National Bank checking account	(350)
5. Reconciled balance in Second National Bank checking account	9,350
6. Balance in City Federal savings account	8,560
7. Customer's postdated check	1,350
8. Employee travel advances	1,600
9. Cash in bond sinking fund	1,200
10. Bond sinking fund investments	8,090
11. Postage stamps	430

Required

Determine the balance in Atwood's Cash account, and discuss the balance sheet treatment of any items not included as cash.

P7-2 Analyzing Bad Debt Expense In 2008, 3 years after it began operations, the Pearce Corporation decided to change from the direct write-off method of recording bad debts to estimating bad debts. The following information is available to you:

	Year			
	2005	2006	2007	2008
Sales	\$125,000	\$180,000	\$250,000	\$280,000
Credit sales	90,000	158,000	210,000	235,000
Collections on accounts receivable				
2005 sales	78,000	8,500	200	
2006 sales		137,000	15,000	300
2007 sales			178,800	19,500
2008 sales				200,000
Accounts receivable written off				
2005 accounts	2,500	500	300	0
2006 accounts		4,600	700	400
2007 accounts			6,200	1,000
2008 accounts				6,800

Required

- Prepare an analysis to determine Pearce's estimated bad debt expense percentage based upon the average relationship of actual bad debts to credit sales.
- Prepare an analysis to determine Pearce's estimated percentage of allowance for doubtful accounts based on year-end accounts receivable.
- What amount should Pearce record as bad debts expense for 2008 if:
 - Bad debts are estimated as a percentage of credit sales?
 - Allowance for doubtful accounts is estimated as a percentage of outstanding year-end accounts receivable?

P7-3 Analyzing Accounts Receivable The June 30, 2006 balance sheet of the Upham Company included the following information:

Accounts receivable	\$224,000	
Less: Allowance for doubtful accounts	<u>(14,100)</u>	\$209,900
Notes receivable*		<u>21,800</u>
Total receivables		\$231,700

*The company is contingently liable for discounted notes receivable of \$38,000.

During the company's fiscal year ending June 30, 2007 the following transactions occurred:

1. Sales on credit	\$874,600
2. Collections of accounts receivable	841,000
3. Accounts receivable written off as uncollectible	13,800
4. Notes receivable collected	29,000
5. Customer notes received in payment of accounts receivable	72,000
6. Notes receivable discounted that were paid at maturity	36,000
7. Notes receivable discounted that were defaulted, including interest of \$20 and a \$5 fee. This amount is expected to be collected during the 2008 fiscal year	2,025
8. Proceeds from customer notes discounted with recourse (face value \$45,000, accrued interest revenue \$200)	45,075
9. Collections on accounts previously written off	500

10. Sales returns and allowances (on credit sales) 2,000
 11. Bad debts were estimated to be 1.5% of credit sales

Required

1. Prepare journal entries necessary for Upham to record the preceding transactions.
2. Prepare an analysis and schedule that shows the amounts of the accounts receivable, allowance for doubtful accounts, notes receivable, and notes receivable dishonored accounts that will be disclosed on Upham's June 30, 2007 balance sheet.

P7-4 Recording Note Transactions The following information is extracted from the accounting records of the Tara Corporation:

May 1	Received a \$6,000, 12%, 90-day note from V. Leigh, a customer.
May 6	Received a \$9,000, 10%, 120-day note from C. Gable, a customer.
May 11	Discounted the Leigh and Gable notes with recourse at the bank at 13%. In addition, borrowed \$10,000 from the bank for 90 days at 12%. The bank remits the face value less the interest.
July 31	The July bank statement indicated that the Leigh note had been paid.
Sept. 4	Received notice that Gable had defaulted on the May 6 note. The bank charged a fee of \$10. Paid the amount due on the Gable note to the bank. Informed Gable to pay Tara the entire amount due plus 11% interest on the total of the face amount of the note, the accrued interest, and the fee from the maturity date until Gable remits the amount owed.
Sept. 23	Received the amount due from Gable.

Required

Prepare journal entries to record the preceding information, assuming that Tara usually does not discount its notes.

P7-5 Reconstructing Accounts Receivable and Expense Journal Entries The 2008 audit of the accounting records of the Lane Company discloses the following information:

	2007	2008
Accounts receivable (ending)	\$186,000	\$187,100
Allowance for doubtful accounts (ending)	7,400	7,000
Allowance for sales returns and allowances (ending)	4,700	3,916
Gross sales returns and allowances (estimated for the year)	4,900	5,200
Accounts receivable written off during the year	6,800	7,900
Estimated bad debts for the year	7,200	7,500
Actual gross sales returns and allowances for the year	4,700	6,000
Sales discounts not taken at end of year	0	400
Credit sales during the year (terms, 2/10, n/60)	375,000	380,000
Cash collected on accounts receivable during the year (net of discounts taken)	352,000	367,500

Required

1. Reconstruct the journal entries that were made by Lane during 2008 to record changes in the following accounts, assuming sales returns and allowances are estimated in the period of sale and the net price method is used to account for sales discounts.
 - a. Allowance for doubtful accounts
 - b. Allowance for sales returns and allowances
 - c. Accounts receivable
2. What is the 2008 ending balance in each of the accounts in Requirement 1 and how will it be reported on Lane's 2008 financial statements?

P7-6 Cash Discounts The Lambert Corporation sells merchandise at a list price of \$70,000 with accompanying terms of 2/10, n/30 on December 8, 2007. By December 18, 2007, Lambert had collected from customers for merchandise originally billed at \$46,000. By December 31, 2007, additional collections had been received on sales originally billed for \$18,000, and sales returns and allowances of \$1,500 had been granted by Lambert. By January 15, 2008, all the remaining balances due had been collected.

Required

1. Prepare the journal entries using (a) the gross price method and (b) the net price method to record each of the following items:
 - a. The sale of the merchandise
 - b. Collections received by December 18, 2007
 - c. Collections received by December 31, 2007
 - d. Sales returns and allowances (*not* estimated in the period of sale)
 - e. Any required year-end adjustments

- f. Any January 1, 2008 reversing entries
 - g. The collections received by January 15, 2008
2. Calculate the accounts receivable balance that would be reported under (a) the gross price method and (b) the net price method on the Lambert Corporation's December 31, 2007, balance sheet.

P7-7 Aging Accounts Receivable On September 30, 2007 (the end of its fiscal year), the Lufkin Corporation reported accounts receivable of \$331,750 and an allowance for doubtful accounts of \$16,700. During fiscal 2008 the following transactions occurred:

Credit sales (terms, n/EOM)	\$2,017,800
Collections on accounts receivable	1,956,000
Accounts receivable written off	16,200

On September 30, 2008 an aging of the accounts receivable balance indicated the following:

Age	Amount	Estimated Percentage Uncollectible
Under 30 days	\$169,250	0.8%
30–90 days	100,000	1.6
91–180 days	55,900	5.0
181–360 days	38,200	15.0
Over 360 days	14,000	40.0
	<u>\$377,350</u>	

Required

1. Prepare the journal entries necessary to record the credit sales, collections on account, write-off of accounts receivable, and the bad debts expense for Lufkin for fiscal 2008.
2. What are Lufkin's September 30, 2008 balances in Accounts Receivable and in its Allowance for Doubtful Accounts and how will they be disclosed on the September 30, 2008 balance sheet?
3. Compute Lufkin's receivables turnover in days, assuming a 360-day business year (as discussed earlier in the chapter and in the Appendix to Chapter 6). What is your evaluation of its collection policies?

P7-8 Estimating Bad Debts An examination of the accounting records of the Keegan Corporation disclosed the following information for 2007:

Cash sales	\$680,000
Net credit sales	527,000
Accounts receivable (12/31/07)	190,000
Allowance for doubtful accounts (12/31/07, prior to adjustment)	1,500 (debit)

Keegan wishes to examine the effect of various alternative bad debt estimation policies.

Required

1. Prepare the adjusting entry that would be required under each of the following methods:
 - a. Bad debts are estimated at 1.4% of total sales (net).
 - b. Bad debts are estimated at 3% of net credit sales.
 - c. Bad debts are estimated at 7.5% of gross accounts receivable.
 - d. An aging of accounts receivable indicates that half of the outstanding accounts will incur a 3% loss, a quarter will incur a 6% loss, the remaining quarter will incur a 20% loss.
2. Discuss the difference between the income statement and balance sheet approaches to estimating bad debts.

P7-9 Notes Receivable and Notes Receivable Discounted The following notes receivable transactions occurred for the Harris Company during the last three months of the current year. (Assume all notes are dated the day the transaction occurred.)

Oct. 9	Received a \$5,000, 12%, 60-day note from K. Weedon, a customer.
Oct. 12	Received a \$6,000, 10%, 90-day note from M. Black, a customer.
Oct. 15	Discounted the Weedon note with recourse at the bank at 14%.
Nov. 11	Discounted the Black note with recourse at the bank at 15%.
Nov. 16	Received an \$8,000, 12%, 60-day note from B. Butcher, a customer.
Nov. 20	Received a \$6,000, 11%, 120-day note from D. Goldman, a customer.
Dec. 1	Received a \$9,000, 13%, 60-day note from S. Lambert, a customer.
Dec. 8	Received notice that the Weedon note was paid at maturity.
Dec. 10	Discounted the Goldman note with recourse at the bank at 13%.

Required

1. Prepare journal entries to record the preceding note transactions and the necessary adjusting entries on December 31. (Assume that Harris does not normally discount its notes.)
2. Show how Harris Company's notes receivable would be disclosed on the December 31 balance sheet. (Assume these are the only note transactions encountered by Harris during the year.)

P7-10 Assigning Accounts Receivable The Furman Corporation entered into an assignment agreement with a finance company whereby Furman would be advanced 80% of all accounts assigned, less a \$2,000 service charge. During the year, \$300,000 of accounts receivable were assigned, \$220,000 collections were made on outstanding assigned accounts, and \$210,000 was remitted to the finance company. This remittance included interest charges of \$2,100. Sales returns and allowances on assigned accounts amounted to \$5,000.

Required

1. Prepare the journal entries necessary to record the preceding information.
2. Show how the preceding information would be reported on Furman's year-end balance sheet (assume the note payable is short-term).

P7-11 Factoring Accounts Receivable Faerber Textile Company frequently factors its accounts receivable. During 2007, Faerber made credit sales of \$100,000 to customers, under terms of 2/10, n/30. Faerber records its credit sales using the gross price method. From past experience, sales returns and allowances are expected to be minimal. In 2007, Faerber sold \$70,000 of these receivables to a factor. The factor remitted 90% of the accounts receivable factored and charged a 12% commission on the gross amount of the factored receivables. The factoring agreement also requires Faerber to be responsible for any cash discounts taken by customers upon payment of the factored receivables. Faerber is charged for these cash discounts upon reimbursement by the factor. During 2007, sales returns and allowances were \$3,000 on the factored accounts receivable and \$1,300 on the unfactored accounts receivable. The factor collected the remaining amount of the factored receivables, less the 2% discount on 94% of the collected receivables, and returned the balance owed to Faerber. Faerber collected the remaining amount of the unfactored accounts receivable, less the 2% discount on 96% of the collected receivables.

Required

Prepare all the journal entries necessary for Faerber to record the preceding information.

P7-12 Factoring and Assignment of Accounts Receivable The Lazard Corporation has experienced cash flow problems and decides to improve its current cash position by factoring 30% of its receivables and assigning the remainder with the same finance company. The agreement with the finance company stipulates that a 10% commission will be assessed on factored accounts and 15% annual interest will be charged on the outstanding note payable balance related to the assigned accounts. Additionally, the finance company will advance only 80% of the factored and assigned accounts, and Lazard must continue the collection responsibilities on the assigned accounts. At the beginning of the last month of the company's fiscal year, the accounts receivable transferred to the finance company amounted to \$187,000. During the month, collections on factored accounts were \$46,000, and collections on assigned accounts amounted to \$84,000. All collections on assigned accounts plus accrued interest were remitted to the finance company at the end of the month. The remaining amounts owed will be remitted within these months.

Required

1. Prepare all journal entries to record the preceding information on Lazard's books.
2. How would the accounts related to Lazard's factoring and assignment agreements be reported on Lazard's year-end financial statements?

P7-13 AICPA Adapted Examination of Accounts Receivable You are engaged in the annual examination of Faulane Company, a wholesale office supply business, for the year ended June 30, 2007. You have been assigned to examine the accounts receivable. The following information is available at June 30, 2007.

1. Your review of accounts receivable and discussions with the client disclose that the following items are included in the accounts receivable (of both the control and the subsidiary ledgers):
 - a. Accounts with credit balances total \$1,746
 - b. Receivables from officers total \$8,500
 - c. Advances to employees total \$1,411
 - d. Accounts that are definitely uncollectible total \$1,187
2. Uncollectible accounts are estimated to be 0.50% of the year's net credit sales of \$16,750,000.

Required

Prepare any journal entry (entries) required:

1. to reclassify items that are not trade accounts receivable,
2. to write off uncollectible accounts, and
3. to adjust the allowance for doubtful accounts.

P7-14 AICPA Adapted *Allowance for Bad Accounts* The Installment Jewelry Company has been in business for 5 years but has never had an audit made of its financial statements. Engaged to make an audit for 2007, you find that the company's balance sheet carries no allowance for bad accounts, bad accounts having been expensed as written off and recoveries credited to income as collected. The company's policy is to write off at December 31 of each year those accounts on which no collections have been received for 3 months. The installment contracts generally are for 2 years.

On your recommendation the company agrees to revise its accounts for 2007 to give effect to bad account treatment on the allowance basis. The allowance is to be based on a percentage of sales that is derived from the experience of prior years. Statistics for the past 5 years are shown in the following table:

	Charge Sales	Accounts Written Off and Year of Sale			Recoveries and Year of Sale
		(2003)			
2003	\$100,000	\$ 550			
		(2003)	(2004)		(2003)
2004	250,000	1,500	\$1,000		\$100
		(2003)	(2004)	(2005)	(2004)
2005	300,000	500	4,000	\$1,300	400
		(2004)	(2005)	(2006)	(2005)
2006	325,000	1,200	4,500	1,500	500
		(2005)	(2006)	(2007)	(2006)
2007	275,000	2,700	5,000	1,400	600

Accounts receivable at December 31, 2007 were as follows:

2006 Sales	\$ 15,000
2007 Sales	<u>135,000</u>
	<u>\$150,000</u>

Required

Prepare the adjusting journal entry or entries with appropriate explanations to set up the Allowance for Bad Accounts. (Support each item with organized computations; income tax implications should be ignored.)

P7-15 AICPA Adapted *Allowance for Doubtful Accounts* From inception of operations to December 31, 2006, Harris Corporation provided for uncollectible accounts receivable under the allowance method: Provisions were made monthly at 2% of credit sales; bad debts written off were charged to the allowance account; recoveries of bad debts previously written off were credited to the allowance account; and no year-end adjustments to the allowance account were made. Harris's usual credit terms are net 30 days.

The balance in the Allowance for Doubtful Accounts was \$130,000 at January 1, 2007. During 2007, credit sales totaled \$9,000,000, interim provisions for doubtful accounts were made at 2% of credit sales, \$90,000 of bad debts were written off, and recoveries of accounts previously written off amounted to \$15,000. Harris upgraded its computer facility in November 2007 and an aging of accounts receivable was prepared for the first time as of December 31, 2007. A summary of the aging is as follows:

Classification by Month of Sale	Balance in Each Category	Estimated % Uncollectible
Nov.–Dec. 2007	\$1,140,000	2%
July–Oct.	600,000	10
Jan.–June	400,000	25
Prior to 1/1/07	<u>130,000</u>	75
	<u>\$2,270,000</u>	

Based on the review of collectibility of the account balances in the "prior to 1/1/07" aging category, additional receivables totaling \$60,000 were written off as of December 31, 2007. Effective with the year ended December 31, 2007, Harris adopted a new accounting method for estimating the allowance for doubtful accounts at the amount indicated by the year-end aging analysis of accounts receivable.

Required

1. Prepare a schedule analyzing the changes in the allowance for doubtful accounts for the year ended December 31, 2007. Show supporting computations in good form.
2. Prepare the journal entry for the year-end adjustment to the Allowance for Doubtful Accounts balance as of December 31, 2007.

P7-16 AICPA Adapted Correction of Allowance Account From inception of operations in 2004 Summit carried no allowance for doubtful accounts. Uncollectible receivables were expensed as written off, and recoveries were credited to income as collected. On March 1, 2008 (after the 2007 financial statements were issued), management recognized that Summit's accounting policy with respect to doubtful accounts was not correct, and determined that an allowance for doubtful accounts was necessary. A policy was established to maintain an allowance for doubtful accounts based on Summit's historical bad debt loss percentage applied to year-end accounts receivable. The historical bad debt loss percentage is to be recomputed each year based on the relationship of net write-offs to credit sales for all available past years up to a maximum of five years.

Information from Summit's records for five years is as follows:

Year	Credit Sales	Accounts Written Off	Recoveries
2004	\$1,500,000	\$15,000	\$ 0
2005	2,250,000	38,000	2,700
2006	2,950,000	52,000	2,500
2007	3,300,000	65,000	4,800
2008	4,000,000	83,000	5,000

Accounts receivable balances were \$1,250,000 and \$1,460,000 at December 31, 2007 and December 31, 2008 respectively.

Required

1. Prepare the journal entry, with appropriate explanation, to set up the Allowance for Doubtful Accounts as of January 1, 2008. Disregard income taxes. Show supporting computations in good form.
2. Prepare a schedule analyzing the changes in the Allowance for Doubtful Accounts account for the year ended December 31, 2008. Show supporting computations in good form.

P7-17 Comprehensive Receivables Problem The December 31, 2006 balance sheet of the Blackmon Corporation disclosed the following information relating to its receivables:

Accounts receivable	\$245,000	
Less: Allowance for doubtful accounts	<u>(15,000)</u>	
		\$230,000
Notes receivable*		<u>50,000</u>
Total receivables		<u>\$280,000</u>

*The company is contingently liable for a discounted note receivable of \$10,000.

During 2007, credit sales (terms, n/EOM) totaled \$2,200,000 and collections on accounts receivable (unassigned) amounted to \$1,900,000. Uncollectible accounts totaling \$18,000 from several customers were written off, and a \$1,350 accounts receivable previously written off was collected. Additionally, the following transactions relating to Blackmon's receivables occurred during the year:

- Mar. 6 Received payment of \$12,460 on a note from the Renko Company. The payment included interest revenue of \$460.
- Mar. 31 The March bank statement indicated that the discounted note had been paid at maturity.
- May 1 Accepted a 120-day, 13% note from the Licata Company in exchange for its account receivable of \$4,800.
- May 18 Received a \$6,900, 90-day, 12% note from the Eagle Manufacturing Corporation for a credit sale.
- June 2 Discounted both the Licata and Eagle notes with recourse at the bank at 14% (assume that Blackmon normally does not discount its notes).
- July 1 Assigned \$140,000 of accounts receivable to a finance company. Under the terms of the agreement, Blackmon receives 85% of the value of the accounts assigned, less a service charge of \$5,000, and is charged 1.5% per month on the outstanding loan balance.
- July 6 A sales allowance of \$2,500 on an assigned account is allowed by Blackmon.
- July 13 A sales return of \$800 on an assigned account is granted by Blackmon.
- July 31 Collections of \$50,000 are made on assigned accounts. This amount and 1 month's interest are remitted to the finance company.
- Aug. 31 Assigned accounts of \$60,000 are collected, and the remainder of the loan is repaid, including interest.

- Aug. 31 The August bank statement indicated the Eagle note had been paid.
 Sept. 1 The bank notifies Blackmon that Licata defaulted on its note and charges a fee of \$25.
 Sept. 4 Collected the amount due from the Licata Company.
 Dec. 31 Collected interest of \$5,000 on the outstanding notes receivable.

On December 31, 2007 an aging of the accounts receivable balance indicated the following:

Age	Amount	Estimated Percentage Uncollectible
Under 30 days	\$240,487	0.5%
31–60 days	113,421	1.5
61–90 days	30,933	8.0
91–240 days	17,185	35.0
Over 240 days	6,874	70.0
	\$408,900	

Required

- Prepare the journal entries to record the preceding receivable transactions during 2007 and the necessary adjusting entry on December 31, 2007.
- Prepare the receivables portion of Blackmon's December 31, 2007 balance sheet.
- Compute Blackmon's accounts receivable turnover in days, assuming a 365-day business year (as discussed earlier in the chapter and in the Appendix to Chapter 6). What is your evaluation of its collection policies?

P7-18 Reconciliation of Bank and Company Cash Amounts (Appendix) The December 31, 2007 bank statement for Miller Corporation showed a \$2,049.25 balance. On this date the company's Cash account reflected a \$325.60 overdraft. In reconciling these amounts, the following information is discovered:

- Cash on hand for undeposited sales receipts, December 31, 2007, \$130.25.
- Customer NSF check returned with bank statement, \$420.40.
- Cash sales of \$640.25 for the week ended December 18, 2007 were recorded on the books. The cashier reports this amount missing, and it was not deposited in the bank.
- Note receivable of \$2,500 and interest of \$25 collected by the bank and not recorded on the books.
- Deposit in transit December 31, 2007, \$350.00.
- A customer check for \$290.40 in payment of its account was recorded on the books at \$940.20.
- Outstanding checks, \$2,040.55. Includes a duplicate check of \$70.85 to C. Brown, who notified Miller that the original was lost. Miller stopped payment on the original check and has already adjusted the cash account in the accounting records for this amount.

Required

- Prepare a December 31, 2007 bank reconciliation for Miller.
- Prepare any journal entries necessary by Miller to record the information from Requirement 1.

P7-19 Unknown Book Balance (Appendix) The following information pertains to the Cash account of the Nakamoto Corporation for the month of July 2007:

Bank statement

Balance July 31	\$22,639.54
Service charge for July	15.00
NSF check returned with July bank statement	184.50
Note receivable collected by bank (not previously recorded on the books)	2,000.00
Interest on note collected by bank (not previously recorded on the books)	60.00

Books

Balance July 31	?
Cash on hand awaiting deposit	1,824.42
Outstanding checks:	
#257 \$42.17	
#271 \$120.19	
#272 \$80.82	
Deposit in transit	2,420.98

Required 

1. Prepare a bank reconciliation to determine Nakamoto's adjusted cash balance on July 31, 2007.
2. Determine Nakamoto's unadjusted cash balance (per books) on July 31, 2007.
3. Prepare the adjusting entries necessary to bring Nakamoto's cash account balance up to date on July 31, 2007.

P7-20 Bank Reconciliation (Appendix) The Daisy Company received a bank statement for February 2007, as follows:

From: Central Bank, Denver, Co. 80222

To: Daisy Company, 1313 Williams St., Denver, Co. 80218

Date	Checks	Deposits	Balance
Feb. 1			\$4,524.80
7	\$2,700.33	\$8,642.61	
9	3,484.81		
14	6.00 SC	460.00 CM	
16	274.09		
21	4,133.60	3,385.49	
23	69.69 NSF		
28			\$6,344.38
	SC 5 Service Charge	NSF 5 Check Returned	
	CM 5 Credit Memo	DM 5 Debit Memo	

The receipt of \$460 on February 14 was for a \$445 note collected by the bank, plus \$20 current interest, less a \$5 service charge. The company's accounting records contained the following information:

Cash balance on February 28 from the books: \$2,610.42

Cash Disbursements		Cash Receipts	
Check No. 155	\$2,700.33	Feb. 7	\$8,624.61
156	3,484.81	21	3,385.49
157	274.09	All receipts are verified and correct	
158	589.02		
159	4,133.60		
160	2,742.63		

Required

1. Prepare a bank reconciliation on February 28, 2007 for the Daisy Company.
2. Prepare the journal entries that the Daisy Company should record as a result of the reconciliation.

P7-21 AICPA Adapted Comprehensive Reconciliation (Appendix) In auditing the Train Company, you obtain directly from the bank Train's bank statement, canceled checks, and other memoranda which relate to the company's bank account for December 2007. In reconciling the bank balance on December 31, 2007 with that shown on the company's books, you observe the following facts:

1. Balance per bank statement		\$91,174.63
2. Balance per books		59,088.46
3. Outstanding checks, 12/31/07		33,378.82
4. Receipts of 12/31/07 deposited on 1/1/08		5,317.20
5. Service charge for December		22.50
6. Proceeds of bank loan, 12/15/07 omitted from company records (discounted for 3 months at 12% per year)		11,640.00
7. Deposit of 12/20/07 omitted from the bank statement		2,892.41
8. Check of Rome Products Co. charged back on 12/22/07 for lack of countersignature. Redeposited 1/5/08. No entry was made for the chargeback or the redeposit.		873.74
9. Error on bank statement in entering deposit of 12/18/07:		
Correct amount	\$3,182.40	
Entered in statement	<u>3,181.40</u>	1.00
10. Check No. 3917 of Trait Manufacturing Co. charged in error to company's account		2,690.00

11. Proceeds of note of J. Somers & Co. collected by bank 12/11/07 not entered on books:		
Principal	\$2,000.00	
Interest	<u>40.00</u>	
	\$2,040.00	
Less: collection charge	<u>5.00</u>	2,035.00
12. Erroneous debit memo of 12/22/07 to charge company's account with settlement of bank loan, which was paid by check No. 8714 on same date		5,000.00
13. Error on bank statement in entering deposit of 12/4/07		
Entered as	\$4,817.10	
Correct amount	<u>4,807.10</u>	10.00
14. Deposit of Trait Manufacturing Co. of 12/8/07 credited in error to the company		1,819.20

Required

1. Prepare a reconciliation of the Train Company's bank account.
2. Prepare journal entries to adjust the Train Company's books to reflect the correct bank balance on December 31, 2007.

CASES

COMMUNICATION

C7-1 Cash Management

The president of Poor Corporation, who likes to have large balances of cash on hand, has recently been reading articles in highly respected financial magazines about very successful businesses. The president noticed that each company stressed the importance of cash management and internal control in making it a success. The president of Poor Corporation comes to you, the accountant, and asks you to explain the concept of cash management.

Required

Explain the concept of cash management, including the two major subdivisions and their components.

C7-2 Bad Debt Expense

AICPA Adapted When a company has a policy of making sales for which credit is extended, it is reasonable to expect a portion of those sales to be uncollectible. As a result of this, a company must recognize bad debt expense. There are basically two methods of recognizing bad debt expense: (1) direct write-off method, and (2) allowance method.

Required

1. Describe fully both the direct write-off method and the allowance method of recognizing bad debt expense.
2. Explain the reasons why one of these methods is preferable to the other and the reasons why the other method is not usually in accordance with generally accepted accounting principles.

C7-3 Accounts Receivable

The Moore Company is undergoing a period of financial stress due to the depressed economy. The company is in

desperate need of cash. The only liquid asset that the company holds is \$500,000 of accounts receivable.

Required

1. Explain the various types of arrangements that may be used to obtain cash from outstanding accounts receivable.
2. Indicate how each method should be disclosed in the financial statements.
3. If Moore Company decides to sell its accounts receivable, should it account for the transfer as a pledge or a factoring agreement? Why?

C7-4 Receivables Issues

AICPA Adapted Magrath Company has an operating cycle of less than one year and provides credit terms for all of its customers. On April 3, 2007, the company factored, without recourse, some of its accounts receivable.

On August 1, 2007, Magrath sold special order merchandise and received an interest-bearing note due April 30, 2008.

Magrath uses the allowance method to account for uncollectible accounts. During 2007, some accounts were written off as uncollectible, and other accounts previously written off as uncollectible were collected.

Required

1. Explain how Magrath should account for and report the accounts receivable factored on April 3, 2007. Why is this accounting treatment appropriate?
2. Explain how Magrath should report the effects of the interest-bearing note on its income statement for the year ended December 31, 2007 and its December 31, 2007 balance sheet.

3. Explain how Magrath should account for the collection of the accounts previously written off as uncollectible.
4. What are the two basic approaches to estimating uncollectible accounts under the allowance method? What is the rationale for each approach?

C7-5 Bank Reconciliations (Appendix)

A discrepancy usually will exist between a company's bank statement balance and its cash records due to the time lag associated with the use of a checking account. The time lag results in many transactions being recorded on the company's records prior to their appearance on the bank statement. The bank statement balance and the cash records must be brought into agreement to determine their accuracy. This result can be achieved by using a bank reconciliation.

Required

Prepare a written report that explains a bank reconciliation.

C7-6 Lockbox Account Bank Reconciliation (Appendix)

DGK Company maintains a lockbox account to facilitate the collection of its accounts receivable. All of the company's cash receipts from credit sales are sent directly to a post office box held in the company's name, which is accessed directly by bank personnel. Each day the bank processes the receipts, credits DGK's account, and provides the company with a hard copy package, which includes a detail and summary listing of all checks deposited, copies of actual checks, invoices,

enclosures, and envelopes. The company usually receives its hard copy packages a day after the bank has processed the receipts.

In addition, DGK Company has authorized the bank to apply "collected balances" (balances for which the holding period allowed for collection and return of deposited items has elapsed) directly against the company's outstanding line of credit with the bank, unless instructed otherwise by the company. The company receives hard copy notices of amounts applied, generally within two business days.

The accounting records for DGK Company contain the following details for December 2007:

1. Balance per bank for the lockbox account, 12/31/07	\$55,000
2. Balance per books, 12/31/07	50,050
3. Deposit in transit from cash sales	5,000
4. Lockbox receipts, 12/31/07	30,000
5. Collected balances applied to line of credit on 12/31/07	20,000
6. Bank service charge for December	50
7. No checks are drawn on the lockbox account	

Required

1. Explain how a lockbox account might benefit a company.
2. Prepare a December 31, 2007 bank reconciliation of DGK Company's lockbox bank account.
3. Prepare any journal entries necessary to adjust DGK Company's books to reflect the results of the reconciliation performed in Requirement 2. (*Contributed by Daryl G. Krause.*)

CREATIVE AND CRITICAL THINKING

C7-7 Components of Cash

AICPA Adapted Cash is an important asset of a company.

1. What are the normal components of cash?
2. Under what circumstances, if any, do valuation problems arise in connection with cash?

C7-8 Estimated Bad Debts

AICPA Adapted On December 31, 2007, Carme Company had significant amounts of accounts receivable as a result of credit sales to its customers. Carme Company uses the allowance method based on credit sales to estimate bad debts. Based on past experience, 1% of credit sales normally will not be collected. This pattern is expected to continue.

Required

1. Explain the rationale of using the allowance method based on credit sales to estimate bad debts. Contrast this method with the allowance method based on the balance in the trade receivables accounts.
2. Explain how Carme Company should report the allowance for bad debts account on its balance sheet at December 31, 2007. Also, describe the alternatives, if any, for presentation of bad debt expense in Carme Company's 2007 income statement.

C7-9 Cash Discounts

In order to induce prompt payment, the Swope Company offers a cash discount of 2% to customers who make payment on their account within 10 days of the invoice date. The company's bookkeeper is not sure how these discounts should be recorded.

Required

1. Explain the methods of recording accounts receivable with cash discounts.
2. Discuss the theoretical soundness of each method.

C7-10 Assignment and Factoring

AICPA Adapted Marie Company has significant amounts of trade accounts receivable as a result of credit sales to its customers. On October 2, 2007, some trade accounts receivable were assigned to Daniel Finance Company on a with-recourse, nonnotification basis for an advance of 75% of their amount at an interest charge of 20% on the balance outstanding.

On November 3, 2007, other trade accounts receivable were factored on a without-recourse basis. The factor withheld 5% of the trade accounts receivable factored as protection against sales returns and allowances and charged a finance charge of 3%.

Required

1. How should Marie account for subsequent collections on the trade accounts receivable assigned on October 2, 2007, and the payments to Daniel Finance? Why?
2. How should Marie account for the trade accounts receivable factored on November 3, 2007? Why?

C7-11 Receivables Issues

AICPA Adapted Hogan Company uses the net method of accounting for sales discounts. Hogan also offers trade discounts to various groups of buyers. On August 1, 2007, Hogan factored some accounts receivable on a without-recourse basis. Hogan incurred a finance charge.

Hogan also has some notes receivable bearing an appropriate rate of interest. The principal and total interest are due at maturity. The notes were received on October 2, 2007, and mature on October 1, 2008. Hogan's operating cycle is less than one year.

Required

1. Using the net method, how should Hogan account for the sales discounts at the date of sale? What is the rationale for the amount recorded as sales under the net method?
2. a. Using the net method, what is the effect on Hogan's sales revenues and net income when customers do not take the sales discounts?
b. What is the effect of trade discounts on sales revenues and accounts receivable? Why?
c. How should Hogan account for the accounts receivable factored on August 1, 2007? Why?
d. How should Hogan report the effects of the interest-bearing notes receivable on its December 31, 2007 balance sheet and on its income statement for the year ended December 31, 2007? Why?

C7-12 Assignment and Discounting

AICPA Adapted Tidal Company has significant amounts of trade accounts receivable. In March of this year, Tidal assigned specific trade accounts receivable to Herb Finance Company on a with-recourse, nonnotification basis as collateral for a loan. Tidal signed a note and received 70% of the amount assigned. Tidal was charged a 5% finance fee and agreed to pay interest at 12% on the unpaid balance. Some specific accounts of the assigned receivables were written off as uncollectible. The remainder of the trade accounts receivable assigned were collected by Tidal in March and April of this year. Tidal paid Herb Finance in full at the end of April of this year.

Tidal also sold some special order merchandise and received a 90-day, 10%, interest-bearing note receivable on July 1 of this year. After 30 days, the note receivable was discounted with recourse at 14% at a bank.

Required

1. Explain how Tidal should account for the transactions described here for the assignment of trade accounts receivable.

2. a. Explain how Tidal should determine the amount of the discount for the note receivable.
b. Explain how the discounting transaction should be accounted for.

C7-13 Analyzing Coca-Cola's Cash and Receivables Disclosures

Refer to the financial statements and related notes of the Coca-Cola Company in Appendix A of this book.

Required

1. What were the cash and cash equivalents at the end of 2004? What does the company classify as cash equivalents?
2. What were the trade accounts receivable (net) at the end of 2004? At the end of 2003?
3. Assuming that all net operating revenues were net credit sales and that the trade accounts receivable (net) at the end of 2002 were \$2,097 million, compute the receivables turnover for 2004 and 2003. What is your evaluation of the difference?

**C7-14 Ethics and Sales Returns**

At the end of 2007, the accounting firm for which you work is auditing the books of Debitus Publishing Inc. for the first time. Debitus, a calendar year company, publishes textbooks that are used in colleges and universities across the country. These textbooks are purchased by students through their campus bookstores. Debitus normally makes its biggest sales at the beginning of the fall semester. In the past, Debitus has always recorded sales returns in the spring semester when the campus bookstores return any unsold textbooks. This has been satisfactory because the returns have been immaterial in amount.

In 2006, as a promotional strategy to stimulate sales, Debitus began offering bookstores a reduced price if they ordered more textbooks. There is no penalty for returns of these textbooks if the bookstores cannot sell them to customers. This strategy worked; sales increased by 10% during 2006. In early 2007, however, a substantial amount of unsold textbooks were returned by bookstores to Debitus. Continuing the promotional strategy, sales increased by 15% during 2007.

While reviewing the sales returns account for 2007, you notice that the only entry was for the textbooks returned earlier in the year. You note that these returns amounted to about 5% of the sales for the fall semester of 2006. Since this pattern of returns seems to you to be a trend that will continue, you raise the issue with the company controller as to whether all of the "sales" for the fall semester of 2007 are actually revenue. The controller responds, "Of course they are revenue; we sold the textbooks. Just because there will be some returns doesn't mean we haven't made sales. Besides, we don't know what percentage the returns will be; they might be as much as 5 percent, but definitely not more. Furthermore, we have already recorded all those returns at the beginning of 2007 that really applied to 2006. So we already have recorded our fair share of returns for 2007. As

long as we record returns consistently, it will all work out. We don't want a drop in earnings for 2007 because of a change in customer returns; our shareholders wouldn't like that. Let's just leave this issue alone."

Required

From financial reporting and ethical perspectives, what do you think about Debitus Publishing Inc.'s policy in regard to sales returns?

RESEARCH SIMULATION

R7-1 Researching GAAP

Situation

Hamilton Company operates in an industry with numerous competitors. It is experiencing a shortage of cash and decides to obtain money from a large bank by using some of its receivables as collateral. Hamilton pledges \$100,000 of its receivables, is charged a 12% fee on this amount, and notifies these credit customers to make their payments directly to the bank. Hamilton transfers the receivables to the bank and the bank assumes the servicing activities, but Hamilton is responsible for all bad debts, which it reasonably estimates to be 2% of the receivables amount. When the balance of the

receivables pledged is reduced to \$3,000, Hamilton is required to "repurchase" the receivables, notify the remaining credit customers to make payments to it, and reassume the servicing activities. The bank has the right to sell the receivables, except to Hamilton's major competitor. Hamilton's president has asked you how to account for (and record) this transaction.

Directions

Research the related generally accepted accounting principles and prepare a short memo to the president that answers his question. Cite your reference and applicable paragraph numbers.