

CHAPTER 8: REPORTING AND ANALYZING RECEIVABLES



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LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- [1 Identify the different types of receivables.](#)
- [2 Explain how accounts receivable are recognized in the accounts.](#)
- [3 Describe the methods used to account for bad debts.](#)
- [4 Compute the interest on notes receivable.](#)
- [5 Describe the entries to record the disposition of notes receivable.](#)
- [6 Explain the statement presentation of receivables.](#)
- [7 Describe the principles of sound accounts receivable management.](#)
- [8 Identify ratios to analyze a company's receivables.](#)
- [9 Describe methods to accelerate the receipt of cash from receivables.](#)



Feature Story: WHAT'S COOKING?

What major U.S corporation got its start 38 years ago with a waffle iron? *Hint:* It doesn't sell food. *Another hint:* Swoosh. *Another hint:* "Just do it." That's right, **Nike**. In 1971, Nike co-founder Bill Bowerman put a piece of rubber into a kitchen waffle iron, and the trademark waffle sole was born. It seems fair to say that at Nike, "They don't make 'em like they used to."

Nike, was co-founded by Bowerman and Phil Knight, a member of Bowerman's University of Oregon track team. Each began in the shoe business independently during the early 1960s. Bowerman got his start by making hand-crafted running shoes for his University of Oregon track team. Knight, after completing graduate school, started a small business importing low-cost, high-quality shoes from Japan. In 1964, the two joined forces, each contributing \$500, and formed Blue Ribbon Sports, a partnership that marketed Japanese shoes.

It wasn't until 1971 that the company began manufacturing its own line of shoes. With the new shoes came a new corporate name—Nike—the Greek goddess of victory. It is hard to imagine that the company that now boasts a stable full of world-class athletes as promoters at one time had part-time employees selling shoes out of car trunks at track meets on a cash-and-carry basis.

As the business grew, Nike sold its shoes to sporting good shops and department stores on a credit basis. This necessitated receivables management. Today, with sales of \$20.8 billion and accounts receivable of \$3.1 billion, managing accounts receivable is vitally important to Nike's success. If it makes a major mistake with its receivables, it will definitely affect the bottom line.

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In recent years, Nike has expanded its product line to a diverse range of products, including performance equipment such as soccer balls and golf clubs. While this has increased sales revenue, it has also complicated Nike's receivables management efforts. Now, instead of selling shoes at a limited number of retail outlets, it sells its vast number of products to a diverse array of stores, large and small. For example, Nike golf clubs are sold at local country clubs and golf shops across the country, while soccer equipment can be sold directly to customers through Internet sales. This diversification of its customer list complicates matters because Nike has to approve each new store or customer for credit sales, monitor cash collections, and pursue slow-paying accounts. That's a lot of work. Maybe cash-and-carry wasn't so bad after all.



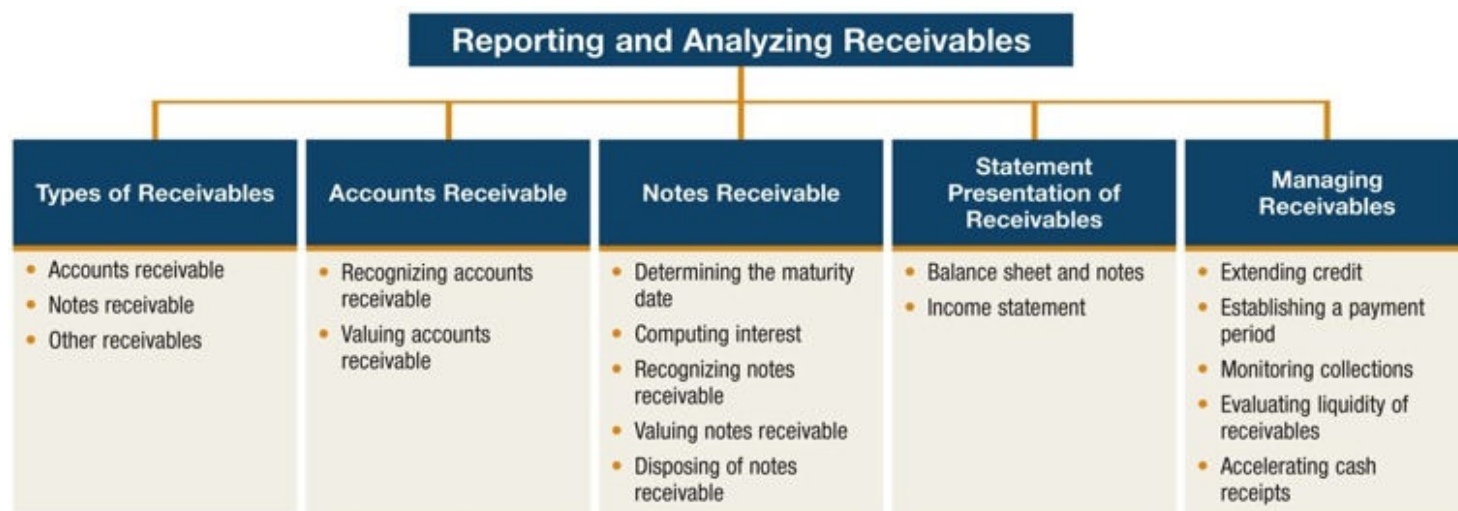
INSIDE CHAPTER 8...

- [When Investors Ignore Warning Signs](#) (p. 406)
- [Can Fair Value Be Unfair?](#) (p. 409)
- [Bad Information Can Lead to Bad Loans](#) (p. 413)
- [eBay for Receivables](#) (p. 418)

PREVIEW OF CHAPTER 8

In this chapter, we discuss some of the decisions related to reporting and analyzing receivables. As indicated in the Feature Story, receivables are a significant asset on the books of Nike. Receivables are important to companies in other industries as well because a larger portion of sales are made on credit in the United States. As a consequence, companies must pay close attention to their receivables balances and manage them carefully. In this chapter, we will look at the accounting and management of receivables at Nike and one of its competitors, Skechers USA.

The organization and content of the chapter are as follows.



LEARNING OBJECTIVE 1

Identify the different types of receivables.

The term **receivables** refers to amounts due from individuals and companies. Receivables are claims that are expected to be collected in cash. The management of receivables is a very important activity for any company that sells goods or services on credit.

Receivables are important because they represent one of a company's most liquid assets. For many companies, receivables are also one of the largest assets. For example, receivables represent 20% of the assets of Nike. [Illustration 8-1](#) lists receivables as a percentage of total assets for five other well-known companies in a recent year.

Illustration 8-1: Receivables as a percentage of assets

Company	Receivables as a Percentage of Total Assets
General Electric	52%
Ford Motor Company	42%
Minnesota Mining and Manufacturing Company (3M)	14%
DuPont Co.	17%
Intel Corporation	5%

The relative significance of a company's receivables as a percentage of its assets depends on various factors: its industry, the time of year, whether it extends long-term financing, and its credit policies. To reflect important differences among receivables, they are frequently classified as (1) accounts receivable, (2) notes receivable, and (3) other receivables.

Accounts receivable are amounts customers owe on account. They result from the sale of goods and services. Companies generally expect to collect accounts receivable within 30 to 60 days. They are usually the most significant type of claim held by a company.

Notes receivable are a written promise (as evidenced by a formal instrument) for amounts to be received. The note normally requires the collection of interest and extends for time periods of 60–90 days or longer. Notes and accounts receivable that result from sales transactions are often called **trade receivables**.

Other receivables include nontrade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable. These do not generally result from the operations of the business. Therefore, they are generally classified and reported as separate items in the balance sheet.

Ethics Note

Accounts Receivable

LEARNING OBJECTIVE 2

Explain how accounts receivable are recognized in the accounts.

Two accounting issues associated with accounts receivable are:

- 1. **Recognizing** accounts receivable.
- 2. **Valuing** accounts receivable.

A third issue, accelerating cash receipts from receivables, is discussed later in the chapter.

RECOGNIZING ACCOUNTS RECEIVABLE

Recognizing accounts receivable is relatively straightforward. A service organization records a receivable when it performs service on account. A merchandiser records accounts receivable at the point of sale of merchandise on account. When a merchandiser sells goods, it increases (debits) Accounts Receivable and increases (credits) Sales Revenue.

The seller may offer terms that encourage early payment by providing a discount. Sales returns also reduce receivables. The buyer might find some of the goods unacceptable and choose to return the unwanted goods.

To review, assume that Jordache Co. on July 1, 2014, sells merchandise on account to Polo Company for \$1,000, terms 2/10, n/30. On July 5, Polo returns merchandise worth \$100 to Jordache Co. On July 11, Jordache receives payment from Polo Company for the balance due. The journal entries to record these transactions on the books of Jordache Co. are as follows. (**Cost of goods sold entries are omitted.**)

July 1	Accounts Receivable—Polo Company	1,000	
	Sales Revenue		1,000
	(To record sales on account)		
July 5	Sales Returns and Allowances	100	
	Accounts Receivable—Polo Company		100
	(To record merchandise returned)		
July 11	Cash (\$900 – \$18)	882	
	Sales Discounts (\$900 × .02)		18

Accounts Receivable—Polo Company

900

(To record collection of accounts receivable)

Helpful Hint

These entries are the same as those described in [Chapter 5](#). For simplicity, we have omitted inventory and cost of goods sold from this set of journal entries and from end-of-chapter material.

Some retailers issue their own credit cards. When you use a retailer's credit card (**JCPenney**, for example), the retailer charges interest on the balance due if not paid within a specified period (usually 25–30 days).

To illustrate, assume that you use your JCPenney Company credit card to purchase clothing with a sales price of \$300 on June 1, 2014. JCPenney will increase (debit) Accounts Receivable for \$300 and increase (credit) Sales Revenue for \$300 (cost of goods sold entry omitted), as follows.

June 1	Accounts Receivable	300	
	Sales Revenue		300

(To record sales on account)

A	=	L	+	SE
+300				
				+300 Rev

Cash Flows

no effect

Assuming that you owe \$300 at the end of the month and JCPenney charges 1.5% per month on the balance due, the adjusting entry that JCPenney makes to record interest revenue of \$4.50 ($\$300 \times 1.5\%$) on June 30 is as follows.

June 30	Accounts Receivable	4.50	
	Interest Revenue		4.50

(To record interest on amount due)

A	=	L	+	SE
+4.50				
				+4.50 Rev

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Cash Flows

no effect

Interest revenue is often substantial for many retailers.

ANATOMY OF A FRAUD

Tasaneer was the accounts receivable clerk for a large non-profit foundation that provided performance and exhibition space for the performing and visual arts. Her responsibilities included activities normally assigned to an accounts receivable clerk, such as recording revenues from various sources that included donations, facility rental fees, ticket revenue, and bar receipts. However, she was also responsible for handling all cash and checks from the time they were received until the time she deposited them, as well as preparing the bank reconciliation. Tasaneer took advantage of her situation by falsifying bank deposits and bank reconciliations so that she could steal cash from the bar receipts. Since nobody else logged the donations or matched the donation receipts to pledges prior to Tasaneer receiving them, she was able to offset the cash that was stolen against donations that she received but didn't record. Her crime was made easier by the fact that her boss, the company's controller, only did a very superficial review of the bank reconciliation and thus didn't notice that some numbers had been cut out from other documents and taped onto the bank reconciliation.

Total take: \$1.5 million

THE MISSING CONTROLS

Segregation of duties. The foundation should not have allowed an accounts receivable clerk, whose job was to record receivables, to also handle cash, record cash, and make deposits, and especially prepare the bank reconciliation.

Independent internal verification. The controller was supposed to perform a thorough review of the bank reconciliation. Because he did not, he was terminated from his position.

Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 183–194.

VALUING ACCOUNTS RECEIVABLE

LEARNING OBJECTIVE 3

Describe the methods used to account for bad debts.

Once companies record receivables in the accounts, the next question is: How should they report receivables in the financial statements? Companies report accounts receivable on the balance sheet as an asset. Determining the **amount** to report is sometimes difficult because some receivables will become uncollectible.

Although each customer must satisfy the credit requirements of the seller before the credit sale is approved, inevitably some accounts receivable become uncollectible. For example, a corporate customer may not be able to pay because it experienced a sales decline due to an economic downturn. Similarly, individuals may be laid off from their jobs or be faced with unexpected hospital bills. The seller records these losses that result from extending credit as **Bad Debt Expense**. Such losses are a normal and necessary risk of doing business on a credit basis.

Recently, when U.S. home prices fell, home foreclosures rose, and the economy in general slowed, lenders experienced huge increases in their bad debt expense. For example, during a recent quarter **Wachovia**, a large U.S. bank now owned by **Wells Fargo**, increased bad debt expense from \$108 million to \$408 million. Similarly, **American Express** increased its bad debt expense by 70%.

Direct Write-Off Method for Uncollectible Accounts

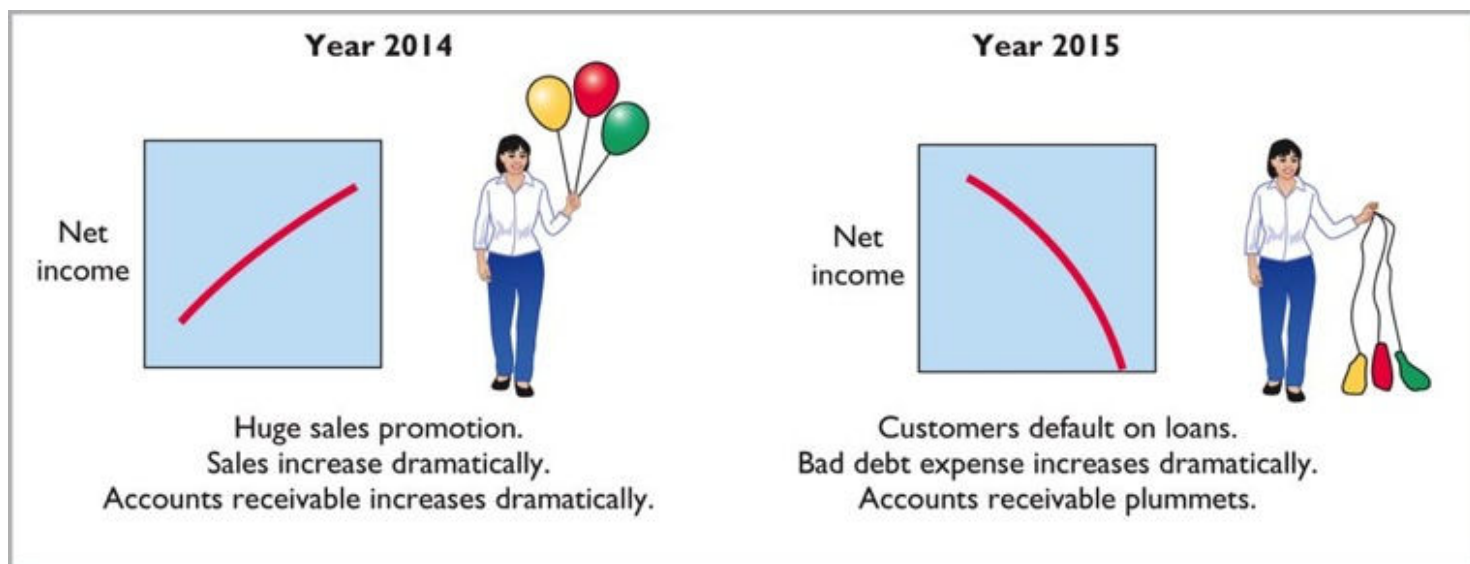
Dec. 12	Bad Debt Expense	200
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(To record write-off of M. E. Doran account)

Cash Flows
no effect

Use of the direct write-off method can reduce the usefulness of both the income statement and balance sheet. Consider the following example. In 2014 Quick Buck Computer Company decided it could increase its revenues by offering computers to college students without requiring any money down, and with no credit-approval process. It went on campuses across the country and sold one million computers at a selling price of \$800 each. This promotion increased Quick Buck's revenues and receivables by \$800,000,000. It was a huge success: The 2014 balance sheet and income statement looked wonderful. Unfortunately, during 2015, nearly 40% of the college student customers defaulted on their loans. The 2015 income statement and balance sheet looked terrible. [Illustration 8-2](#) shows the effect of these events on the financial statements using the direct write-off method.

Illustration 8-2: Effects of direct write-off method



Under the direct write-off method, companies often record bad debt expense in a period different from the period in which they recorded the revenue. Thus, no attempt is made to match bad debt expense to sales revenues in the income statement. Nor does the company try to show accounts receivable in the balance sheet at the amount actually expected to be received. Consequently, unless a company expects bad debt losses to be insignificant, **the direct write-off method is not acceptable for financial reporting purposes.**

Allowance Method for Uncollectible Accounts

The [allowance method](#) of accounting for bad debts involves estimating uncollectible accounts at the end of each period. This provides better matching of expenses with revenues on the income statement. It also ensures that receivables are stated at their cash (net) realizable value on the balance sheet. [Cash \(net\) realizable value](#) is the net amount a company expects to receive in cash from receivables. It excludes amounts that the company estimates it will not collect. Estimated uncollectible receivables therefore reduce receivables on the balance sheet through use of the allowance method.

Helpful Hint

In this context, *material* means significant or important to financial statement users.

Companies must use the allowance method for financial reporting purposes when bad debts are material in amount. It has three essential features:

- 1. Companies **estimate** uncollectible accounts receivable and **match them against revenues** in the same accounting period in which the revenues are recorded.
- 2. Companies record estimated uncollectibles as an increase (a debit) to Bad Debt Expense and an increase (a credit) to Allowance for Doubtful Accounts through an adjusting entry at the end of each period. Allowance for Doubtful Accounts is a contra account to Accounts Receivable.
- 3. Companies debit actual uncollectibles to Allowance for Doubtful Accounts and credit them to Accounts Receivable at the time the specific account is written off as uncollectible.

RECORDING ESTIMATED UNCOLLECTIBLES.

To illustrate the allowance method, assume that Hampson Furniture has credit sales of \$1,200,000 in 2014, of which \$200,000 remains uncollected at December 31. The credit manager estimates that \$12,000 of these sales will prove uncollectible. The adjusting entry to record the estimated uncollectibles increases (debits) Bad Debt Expense and increases (credits) Allowance for Doubtful Accounts, as follows.

Allowance for Doubtful Accounts

12,000

(To record estimate of uncollectible accounts)

A	=	L	+	SE
				- 12,000 Exp
- 12,000				

Cash Flows

no effect

Companies report Bad Debt Expense in the income statement as an operating expense (usually as a selling expense). Thus, Hampson matches the estimated uncollectibles with sales in 2014 because the expense is recorded in the same year the company makes the sales.

Allowance for Doubtful Accounts shows the estimated amount of claims on customers that companies expect will become uncollectible in the future. Companies use a contra account instead of a direct credit to Accounts Receivable because they do not know which customers will not pay. The credit balance in the allowance account will absorb the specific write-offs when they occur. The company deducts the allowance account from Accounts Receivable in the current assets section of the balance sheet, as shown in [Illustration 8-3](#).

Illustration 8-3: Presentation of allowance for doubtful accounts

HAMPSON FURNITURE

Balance Sheet (partial)

Current assets			
Cash			\$ 14,800
Accounts receivable		\$200,000	
Less: Allowance for doubtful accounts	<u>12,000</u>		188,000
Inventory			310,000
Supplies		<u>25,000</u>	

HAMPSON FURNITURE

Balance Sheet (partial)

Total current assets	\$537,800
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The amount of \$188,000 in [Illustration 8-3](#) represents the expected **cash realizable value** of the accounts receivable at the statement date. **Companies do not close Allowance for Doubtful Accounts at the end of the fiscal year.**

RECORDING THE WRITE-OFF OF AN UNCOLLECTIBLE ACCOUNT.

Various methods are used to collect past-due accounts. When a company exhausts all means of collecting a past-due account and collection appears unlikely, the company writes off the account. In the credit card industry, it is standard practice to write off accounts that are 210 days past due. To prevent premature or unauthorized write-offs, authorized management personnel should formally approve each write-off. **To maintain segregation of duties, the employee authorized to write off accounts should not have daily responsibilities related to cash or receivables.**

To illustrate a receivables write-off, assume that the vice president of finance of Hampson Furniture on March 1, 2015, authorizes a write-off of the \$500 balance owed by R. A. Ware. The entry to record the write-off is:

Mar. 1	Allowance for Doubtful Accounts	500	
	Accounts Receivable—R. A. Ware		500

(Write-off of R. A. Ware account)

A	=	L	+	SE
+ 500				
– 500				

Cash Flows

no effect

The company does not increase Bad Debt Expense when the write-off occurs. **Under the allowance method, a company debits every bad debt write-off to the allowance account and not to Bad Debt Expense.** A debit to Bad Debt Expense would be incorrect because the company has already recognized the expense when it made the adjusting entry for estimated bad debts. Instead, the entry to record the write-off of an uncollectible account reduces both Accounts Receivable and Allowance for Doubtful Accounts. After posting, the general ledger accounts appear as shown in [Illustration 8-4](#).

Illustration 8-4: General ledger balances after write-off

Jan. 1 Bal. 200,000	Mar. 1 500	Mar. 1 500	Jan. 1 Bal. 12,000
Accounts Receivable		Allowance for Doubtful Accounts	
Mar. 1 Bal. 199,500			Mar. 1 Bal. 11,500

A write-off affects only balance sheet accounts. Cash realizable value in the balance sheet, therefore, remains the same before and after the write-off, as shown in [Illustration 8-5](#).

Illustration 8-5: Cash realizable value comparison

	Before Write-Off	After Write-Off
Accounts receivable	\$ 200,000	\$ 199,500
Allowance for doubtful accounts	<u>12,000</u>	<u>11,500</u>
Cash realizable value	\$188,000	\$188,000

RECOVERY OF AN UNCOLLECTIBLE ACCOUNT.

Occasionally, a company collects from a customer after the account has been written off as uncollectible. The company must make two entries to record the recovery of a bad debt: (1) It reverses the entry made in writing off the account. This reinstates the customer’s account. (2) It journalizes the collection in the usual manner.

To illustrate, assume that on July 1, R. A. Ware pays the \$500 amount that Hampson Furniture had written off on March 1. Hampson makes these entries:

(1)

July 1	Accounts Receivable—R. A. Ware	500
	Allowance for Doubtful Accounts	500

(To reverse write-off of R. A. Ware account)

A	=	L	+	SE
+500				
−500				

Cash Flows

no effect

(2)

1 Cash 500

Accounts Receivable—R. A. Ware 500

(To record collection from R. A. Ware)

A	=	L	+	SE
+500				
−500				

Cash Flows

+500



Note that the recovery of a bad debt, like the write-off of a bad debt, affects only balance sheet accounts. The net effect of the two entries is an increase in Cash and an increase in Allowance for Doubtful Accounts for \$500. Accounts Receivable and Allowance for Doubtful Accounts both increase in entry (1) for two reasons. First, the company made an error in judgment when it wrote off the account receivable. Second, R. A. Ware did pay, and therefore the Accounts Receivable account should show this reinstatement and collection for possible future credit purposes.

Helpful Hint

Like the write-off, a recovery does not involve the income statement.

ESTIMATING THE ALLOWANCE.

For Hampson Furniture in [Illustration 8-3](#), the amount of the expected uncollectibles was given. However, in “real life,” companies must estimate the amount of expected uncollectible accounts if they use the allowance method. [Illustration 8-6](#) shows an excerpt from the notes to Nike’s financial statements discussing its use of the allowance method.



NIKE, INC.

Notes to the Financial Statements

Allowance for Uncollectible Accounts Receivable

We make ongoing estimates relating to the ability to collect our accounts receivable and maintain an allowance for estimated losses resulting from the inability of our customers to make required payments. In determining the amount of the allowance, we consider our historical level of credit losses and make judgments about the creditworthiness of significant customers based on ongoing credit evaluations. Since we cannot predict future changes in the financial stability of our customers, actual future losses from uncollectible accounts may differ from our estimates.

Frequently, companies estimate the allowance as a percentage of the outstanding receivables. Under the [percentage-of-receivables basis](#), management establishes a percentage relationship between the amount of receivables and expected losses from uncollectible accounts. For example, suppose Steffen Company has an ending balance in Accounts Receivable of \$200,000, and an unadjusted credit balance in Allowance for Doubtful Accounts of \$1,500. It estimates that 5% of its accounts receivable will eventually be uncollectible. It should report a balance in Allowance for Doubtful Accounts of \$10,000 ($.05 \times \$200,000$). To increase the balance in Allowance for Doubtful Accounts from \$1,500 to \$10,000, the company debits (increases) Bad Debt Expense and credits (increases) Allowance for Doubtful Accounts by \$8,500 ($\$10,000 - \$1,500$).

Helpful Hint

Where appropriate, the percentage-of-receivables basis may use only a single percentage rate.

Allowance for Doubtful Accounts

Dec. 31 Unadj.

Bal. 1,500

Dec. 31 Adj. **8,500**

Dec. 31 Bal. 10,000

To more accurately estimate the ending balance in the allowance account, a company often prepares a schedule, called [aging the accounts receivable](#). This schedule classifies customer balances by the length of time they have been unpaid.

After the company arranges the accounts by age, it determines the expected bad debt losses by applying percentages, based on past experience, to the totals of each category. The longer a receivable is past due, the less likely it is to be collected. As a result, the estimated percentage of uncollectible debts increases as the number of days past due increases. [Illustration 8-7](#) shows an aging schedule for Dart Company. Note the increasing uncollectible percentages from 2% to 40%.

Illustration 8-7: Aging schedule

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Customer	Total	Not Yet Due	Number of Days Past Due			
1-30	31 -60	61-90	Over 90			
T. E. Adert	\$ 600		\$ 300	\$ 200	\$ 100	
R. C. Bortz	300	\$ 300				
B. A. Carl	450		200	\$ 250		
O. L. Diker	700	500			200	
T. O. Ebbet	600			300		300
Others	36,950	26,200	5,200	2,450	1,600	1,500
	\$39,600	\$27,000	\$5,700	\$3,000	\$2,000	\$1,900
Estimated percentage uncollectible		2%	4%	10%	20%	40%
Total estimated uncollectible accounts	\$ 2,228	\$ 540	\$ 228	\$ 300	\$ 400	\$ 760

Total estimated uncollectible accounts for Dart Company (\$2,228) represent the existing customer claims expected to become uncollectible in the future. Thus, this amount represents the **required balance** in Allowance for Doubtful Accounts at the balance sheet date. Accordingly, **the amount of bad debt expense that should be recorded in the adjusting entry is the difference between the required balance and the existing balance in the allowance account.** The existing, unadjusted balance in Allowance for Doubtful Accounts is the net result of the beginning balance (a normal credit balance) less the write-offs of specific accounts during the year (debits to the allowance account).

For example, if the unadjusted trial balance shows Allowance for Doubtful Accounts with a credit balance of \$528, then an adjusting entry for \$1,700 (\$2,228 – \$528) is necessary:

Dec. 31	Bad Debt Expense	1,700	
	Allowance for Doubtful Accounts		1,700
	(To adjust allowance account to total estimated uncollectibles)		

A	=	L	+	SE
				–1,700 Exp
–1,700				

Cash Flows

no effect

After Dart posts the adjusting entry, its accounts appear as shown in [Illustration 8-8](#).

Illustration 8-8: Bad debt accounts after posting

Bad Debt Expense Allowance for Doubtful Accounts

Dec. 31 Adj. **1,700** Dec. 31 Unadj.

Bal. 528

Dec. 31 Adj. **1,700**

Dec. 31 Bal. 2,228

An important aspect of accounts receivable management is simply maintaining a close watch on the accounts. Studies have shown that accounts more than 60 days past due lose approximately 50% of their value if no payment activity occurs within the next 30 days. For each additional 30 days that pass, the collectible value halves once again.

Occasionally, the allowance account will have a **debit balance** prior to adjustment. This occurs because the debits to the allowance account from write-offs during the year **exceeded** the beginning balance in the account which was based on previous estimates for bad debts. In such a case, the company **adds the debit balance to the required balance** when it makes the adjusting entry. Thus, if there was a \$500 **debit** balance in the allowance account before adjustment, the adjusting entry would be for \$2,728 (\$2,228 + \$500) to arrive at a credit balance of \$2,228 (see T-account in margin).

Allowance for Doubtful Accounts

Dec. 31 Unadj.

Bal. 500

Dec. 31

Adj. 2,728

Allowance for Doubtful Accounts

Dec. 31
Bal. 2,228

The percentage-of-receivables basis provides an estimate of the cash realizable value of the receivables. It also provides a reasonable matching of expense to revenue.



DECISION TOOLKIT

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
Is the amount of past due accounts increasing? Which accounts require management’s attention?	List of outstanding receivables and their due dates	Prepare an aging schedule showing the receivables in various stages: outstanding 0–30 days, 31–60 days, 61–90 days, and over 90 days.	Accounts in the older categories require follow-up: letters, phone calls, and possible renegotiation of terms.

The following note regarding accounts receivable comes from the annual report of the shoe company **Skechers USA**.

Illustration: 8-9: Skechers USA's note disclosure of accounts receivable
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SKECHERS USA

Notes to the Financial Statements

Gross trade accounts receivable balance were \$196.4 million and \$285.8 million and the allowance for bad debts, returns, sales allowances and customer chargebacks was \$20.4 million and \$19.7 million, at December 31, 2011 and 2010, respectively. The Company's credit losses due to write-offs for the years ended December 31, 2011, 2010 and 2009 were \$7.0 million, \$4.8 million and \$1.2 million, respectively.



Ethics Insight: When Investors Ignore Warning Signs

At one time, **Nortel Networks** announced that half of its previous year's earnings were "fake." Should investors have seen this coming? Well, there were issues in its annual report that should have caused investors to ask questions. The company had cut its allowance for doubtful accounts on all receivables from \$1,253 million to \$544 million even though its total balance of receivables remained relatively unchanged.



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This reduction in bad debt expense was responsible for a very large part of the company's earnings that year. At the time, it was unclear whether Nortel might have set the reserves too high originally and needed to reduce them, or whether it slashed the allowance to artificially boost earnings. But one thing is certain—when a company makes an accounting change of this magnitude, investors need to ask questions.

Source: Jonathan Weil, "Outside Audit: At Nortel, Warning Signs Existed Months Ago," *Wall Street Journal* (May 18, 2004), p. C3.



When would it be appropriate for a company to lower its allowance for doubtful accounts as a percentage of its receivables? (See [page 443](#).)

Do it! BAD DEBT EXPENSE

Brule Corporation has been in business for 5 years. The unadjusted trial balance at the end of the current year shows Accounts Receivable \$30,000; Sales Revenue \$180,000; and Allowance for Doubtful Accounts with a debit balance

Action Plan

- Report receivables at their cash (net) realizable value—that is, the amount the company expects to collect in cash.
- Estimate the amount the company does not expect to collect.
- Consider the existing balance in the allowance account when using the percentage-of-receivables-basis.

Solution

Brule should make the following entry to bring the debit balance in Allowance for Doubtful Accounts up to a normal, credit balance of \$3,000 ($10\% \times \$30,000$):

Bad Debt Expense [$(10\% \times \$30,000) + \$2,000$] 5,000

Allowance for Doubtful Accounts 5,000

(To record estimate of uncollectible accounts)

Related exercise material: [BE8-3](#), [BE8-4](#), [BE8-5](#),  [8-1](#), [E8-3](#), [E8-4](#), [E8-5](#), and [E8-6](#).



Notes Receivable

LEARNING OBJECTIVE 4

Compute the interest on notes receivable.

Companies also may grant credit in exchange for a formal credit instrument known as a promissory note. A [promissory note](#) is a written promise to pay a specified amount of money on demand or at a definite time. Promissory notes may be used (1) when individuals and companies lend or borrow money, (2) when the amount of the transaction and the credit period exceed normal limits, and (3) in settlement of accounts receivable.

In a promissory note, the party making the promise to pay is called the [maker](#). The party to whom payment is to be made is called the [payee](#). The promissory note may specifically identify the payee by name or may designate the payee simply as the bearer of the note.

In the note shown in [Illustration 8-10](#), Brent Company is the maker, and Wilma Company is the payee. To Wilma Company, the promissory note is a note receivable. To Brent Company, the note is a note payable.

Illustration 8-10: Promissory note

The diagram shows a promissory note form with the following fields and labels:

- Amount:** \$1,000
- Date Due:** 2 months after date
- Date of Note:** Chicago, Illinois May 1, 2014
- Payee:** Wilma Company
- Amount:** One Thousand and no/100 dollars
- Interest Rate:** 8%
- Maker:** Brent Company
- Treasurer:** Phyllis Miller

Helpful Hint

Who are the two key parties to a note? What entry does each party make when the note is issued?

Answer:

- 1. The maker, Brent Company, credits Notes Payable.
- 2. The payee, Wilma Company, debits Notes Receivable.

Notes receivable give the holder a stronger legal claim to assets than do accounts receivable. Like accounts receivable, notes receivable can be readily sold to another party. Promissory notes are negotiable instruments (as are checks), which means that, when sold, the seller can transfer them to another party by endorsement.

Companies frequently accept notes receivable from customers who need to extend the payment of an outstanding account receivable. Companies also often require notes from high-risk customers. In some industries (e.g., the pleasure and sport boat industry), all credit sales are supported by notes. The majority of notes, however, originate from lending transactions.

There are five issues in accounting for notes receivable:

- 1. **Determining** the maturity date.
- 2. **Computing** interest.
- 3. **Recognizing** notes receivable.
- 4. **Valuing** notes receivable.
- 5. **Disposing** of notes receivable.

We look at each of these issues.

DETERMINING THE MATURITY DATE

The maturity date of a promissory note may be stated in one of three ways: (1) on demand, (2) on a stated date, and (3) at the end of a stated period of time. When it is stated to be at the end of a period of time, the parties to the note

will need to determine the maturity date.

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Helpful Hint

The maturity date of a 60-day note dated July 17 is determined as follows.

Term of note 60 days

July (31 – 17) 14

August 31 45

September 15

(Maturity date)

When the life of a note is expressed in terms of months, you find the date when it matures by counting the months from the date of issue. For example, the maturity date of a three-month note dated May 1 is August 1. A note drawn on the last day of a month matures on the last day of a subsequent month. That is, a July 31 note due in two months matures on September 30.

When the due date is stated in terms of days, you need to count the exact number of days to determine the maturity date. In counting, **omit the date the note is issued but include the due date.**

COMPUTING INTEREST

[Illustration 8-11](#) gives the basic formula for computing interest on an interest-bearing note.

Illustration 8-11: Formula for computing interest

$$\text{Face Value of Note} \times \text{Annual Interest Rate} \times \text{Time in Terms of One Year} = \text{Interest}$$

The interest rate specified on the note is an **annual** rate of interest. The time factor in the computation expresses the fraction of a year that the note is outstanding. When the maturity date is stated in days, the time factor is frequently the number of days divided by 360. **When counting days, omit the date the note is issued but include the due date.** When the due date is stated in months, the time factor is the number of months divided by 12. [Illustration 8-12](#) shows computation of interest for various time periods.

Illustration 8-12: Computation of interest

Terms of Note	Interest Computation
	Face × Rate × Time = Interest

Terms of Note

Interest Computation

$$\text{\$ 730, 12\%, 120 days} \quad \text{\$ 730} \times 12\% \times \text{120/360} = \text{\$ 29.20}$$

$$\text{\$1,000, 9\%, 6 months} \quad \text{\$1,000} \times 9\% \times \text{6/12} = \text{\$ 45.00}$$

$$\text{\$2,000, 6\%, 1 year} \quad \text{\$2,000} \times 6\% \times \text{1/1} = \text{\$120.00}$$

There are different ways to calculate interest. For example, the computation in [Illustration 8-12](#) assumes 360 days for the year. Most financial institutions use 365 days to compute interest. *For homework problems, assume 360 days to simplify computations.*

RECOGNIZING NOTES RECEIVABLE

To illustrate the basic entry for notes receivable, we will use Brent Company's \$1,000, two-month, 8% promissory note dated May 1. Assuming that Brent Company wrote the note to settle an open account, Wilma Company makes the following entry for the receipt of the note.

May 1	Notes Receivable	1,000
	Accounts Receivable—Brent Company	1,000

(To record acceptance of Brent Company note)

A	=	L	+	SE
+1,000				
−1,000				

Cash Flows

no effect

The company records the note receivable at its **face value**, the value shown on the face of the note. No interest revenue is reported when the company accepts the note because the revenue recognition principle does not recognize revenue until the performance obligation is satisfied. Interest is earned (accrued) as time passes.

If a company issues cash in exchange for a note, the entry is a debit to Notes Receivable and a credit to Cash in the amount of the loan.

VALUING NOTES RECEIVABLE

Like accounts receivable, companies report short-term notes receivable at their cash (net) realizable value. The notes receivable allowance account is Allowance for Doubtful Accounts. Valuing short-term notes receivable is the same as valuing accounts receivable. The computations and estimations involved in determining cash realizable value and in recording the proper amount of bad debt expense and related allowance are similar.

Long-term notes receivable, however, pose additional estimation problems. As an example, we need only look at the problems large U.S. banks sometimes have in collecting their receivables. Loans to less-developed countries are particularly worrisome. Developing countries need loans for development but often find repayment difficult. In some cases, developed nations have intervened to provide financial assistance to the financially troubled borrowers so as to minimize the political and economic turmoil to the borrower and to ensure the survival of the lender.



International Insight: Can Fair Value Be Unfair?

The FASB and the International Accounting Standards Board (IASB) are considering proposals for how to account for financial instruments. The FASB has proposed that loans and receivables be accounted for at their fair value (the amount they could currently be sold for), as are most investments. The FASB believes that this would provide a more accurate view of a company's financial position. It might be especially useful as an early warning when a bank is in trouble because of poor-quality loans. But, banks argue that fair values are difficult to estimate accurately. They are also concerned that volatile fair values could cause large swings in a bank's reported net income.





What are the arguments in favor of and against fair value accounting for loans and receivables? (See [page 443](#).)

DISPOSING OF NOTES RECEIVABLE

LEARNING OBJECTIVE 5

Describe the entries to record the disposition of notes receivable.

Notes may be held to their maturity date, at which time the face value plus accrued interest is due. In some situations, the maker of the note defaults, and the payee must make an appropriate adjustment. In other situations, similar to accounts receivable, the holder of the note speeds up the conversion to cash by selling the receivables (as described later in this chapter).

Honor of Notes Receivable

A note is **honored** when its maker pays in full at its maturity date. For each interest-bearing note, the **amount due at maturity** is the face value of the note plus interest for the length of time specified on the note.

Helpful Hint

How many days of interest should be accrued at September 30 for a 90-day note issued on August 16? Answer: 45 days (15 days in August plus 30 days in September).

To illustrate, assume that Wolder Co. lends Higley Inc. \$10,000 on June 1, accepting a five-month, 9% interest note.

In this situation, interest is $\$375 \left(\$10,000 \times 9\% \times \frac{5}{12} \right)$. The amount due, the **maturity value**, is $\$10,375 \left(\$10,000 + \$375 \right)$. To obtain payment, Wolder (the payee) must present the note either to Higley Inc. (the maker) or to the maker's agent, such as a bank. If Wolder presents the note to Higley Inc. on November 1, the maturity date, Wolder's entry to record the collection is:

Nov. 1	Cash	10,375
	Notes Receivable	10,000
	Interest Revenue $\left(\$10,000 \times 9\% \times \frac{5}{12} \right)$	375

(To record collection of Higley Inc. note and interest)

A	=	L	+	SE
+10,375				
-10,000				
				+375 Rev

Cash Flows

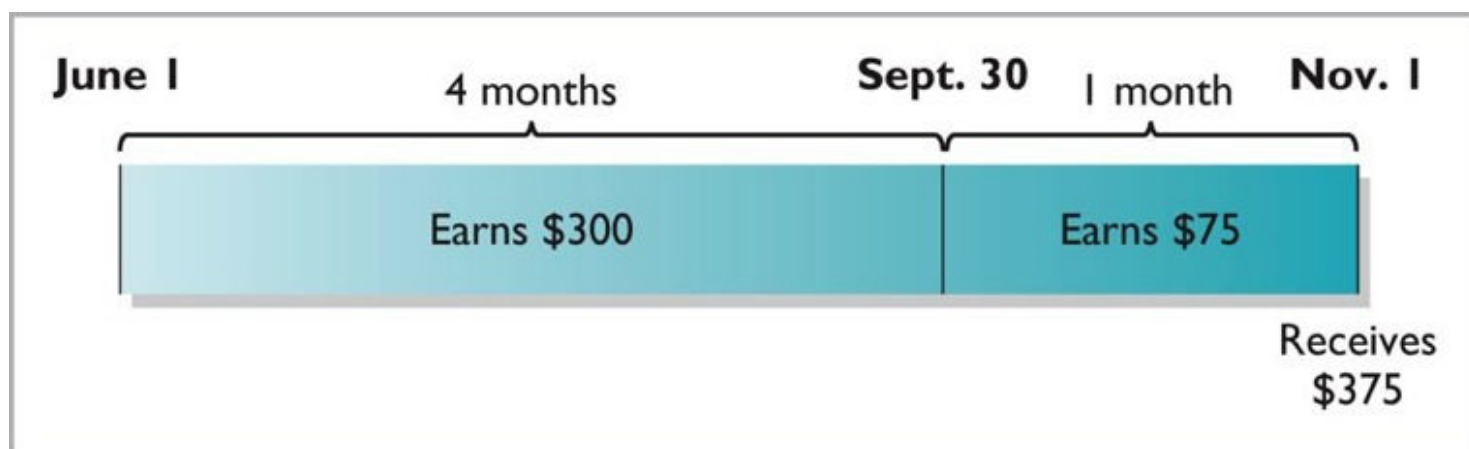
+10,375



Accrual of Interest Receivable

Suppose instead that Wolder Co. prepares financial statements as of September 30. The timeline in [Illustration 8-13](#) presents this situation.

Illustration 8-13: Timeline of interest earned



To reflect interest earned but not yet received, Wolder must accrue interest on September 30. In this case, the adjusting entry by Wolder is for four months of interest, or \$300, as shown below.

Sept. 30	Interest Receivable	$\left(\$ 10,000 \times 9\% \times \frac{4}{12} \right)$	300
	Interest Revenue		300

(To accrue 4 months' interest on Higley note)

A	=	L	+	SE
+300				
				+300 Rev

Cash Flows

no effect

At the note's maturity on November 1, Wolder receives \$10,375. This amount represents repayment of the \$10,000 note as well as five months of interest, or \$375, as shown on the next page. The \$375 is comprised of the \$300 Interest Receivable accrued on September 30 plus \$75 earned during October. Wolder's entry to record the honoring of the Higley note on November 1 is:

Nov. 1	Cash	$\left[\$10,000 + \left(\$10,000 \times 9\% \times \frac{5}{12} \right) \right]$	10,375
	Notes Receivable		10,000
	Interest Receivable		300
	Interest Revenue	$\left(\$10,000 \times 9\% \times \frac{1}{12} \right)$	75

(To record collection of Higley Inc. note and interest)

A	=	L	+	SE
+10,375				
-10,000				
-300				
				+75 Rev

Cash Flows

+10,375



In this case, Wolder credits Interest Receivable because the receivable was established in the adjusting entry on September 30.

Dishonor of Notes Receivable

A **dishonored (defaulted) note** is a note that is not paid in full at maturity. A dishonored note receivable is no longer negotiable. However, the payee still has a claim against the maker of the note for both the note and the interest. If the lender expects that it eventually will be able to collect, the two parties negotiate new terms to make it easier for the borrower to repay the debt. If there is no hope of collection, the payee should write off the face value of the note.

NOTES RECEIVABLE

Gambit Stores accepts from Leonard Co. a \$3,400, 90-day, 6% note dated May 10 in settlement of Leonard's overdue open account. The note matures on August 8. What entry does Gambit make at the maturity date, assuming Leonard pays the note and interest in full at that time?

Action Plan

- Determine whether interest was accrued.
- Compute the accrued interest.
- Prepare the entry for payment of the note and the interest. The entry to record interest at maturity in this solution assumes that no interest has been previously accrued on this note.

Solution

The interest payable at maturity date is \$51, computed as follows.

$$\begin{array}{rclcl} \text{Face} & \times & \text{Rate} & \times & \text{Time} & = & \text{Interest} \\ \$3,400 & \times & 6\% & \times & \frac{90}{360} & = & \$51 \end{array}$$

Gambit Stores records this entry at the maturity date:

Cash	3,451
Notes Receivable	3,400
Interest Revenue	51

(To record collection of Leonard note and interest)

Related exercise material: [BE8-6](#), [BE8-7](#),  [8-2](#), [E8-7](#), and [E8-8](#).



Financial Statement Presentation of Receivables

Explain the statement presentation of receivables.

Companies should identify in the balance sheet or in the notes to the financial statements each of the major types of receivables. Short-term receivables are reported in the current assets section of the balance sheet, below short-term investments. Short-term investments appear before short-term receivables because these investments are nearer to cash. Companies report both the gross amount of receivables and the allowance for doubtful accounts.

Receivables represent 53% of the total assets of heavy equipment manufacturer Deere & Company. [Illustration 8-14 \(page 412\)](#) shows a presentation of receivables for Deere & Company from its balance sheet and notes in a recent year.

Illustration 8-14: Balance sheet presentation of receivables



DEERE & COMPANY

Balance Sheet (partial)

(in millions)

Receivables

Receivables from unconsolidated subsidiaries	\$ 38
Trade accounts and notes receivable	2,694
Financing receivables	15,469
Restricted financing receivables	3,108
Other receivables	<u>864</u>
Total receivables	22,173
Less: Allowance for doubtful trade receivables	<u>290</u>
Net receivables	\$21,883

In the income statement, companies report bad debt expense under “Selling expenses” in the operating expenses section. They show interest revenue under “Other revenues and gains” in the nonoperating section of the income statement.

Managing Receivables

LEARNING OBJECTIVE 7

Describe the principles of sound accounts receivable management.

Managing accounts receivable involves five steps:

- 1. Determine to whom to extend credit.
- 2. Establish a payment period.
- 3. Monitor collections.
- 4. Evaluate the liquidity of receivables.
- 5. Accelerate cash receipts from receivables when necessary.

EXTENDING CREDIT

Every entrepreneur struggles with financing issues. For example, the very first order that **Apple's** founders received was 50 circuit boards to a computer hobby shop. To produce the \$25,000 order, Steve Jobs and Steve Wozniak needed \$15,000 of parts. To purchase the parts, they borrowed \$5,000 from friends but then were turned down when they applied for a bank loan for the \$10,000 balance. They approached two parts suppliers in an effort to negotiate a purchase on credit, but both suppliers said no. Finally, a third supplier agreed to sell them the parts on 30-day credit after he called the computer hobby shop to confirm that it had, in fact, placed a \$25,000 order to purchase goods.

A critical part of managing receivables is determining who should be extended credit and who should not. Many companies increase sales by being generous with their credit policy. However, they sometimes extend credit to risky customers who do not pay. But if your credit policy is too tight, you will lose sales. If it is too loose, you may sell to "deadbeats" who will pay either very late or not at all. One CEO noted that prior to getting his credit and collection department in order, his salespeople had 300 square feet of office space **per person**, while the people in credit and collections had six people crammed into a single 300-square-foot space. Although this focus on sales boosted sales revenue, it had very expensive consequences in bad debt expense.

Companies can take certain steps to help minimize losses due to bad debts when they decide to relax credit standards for new customers. They might require risky customers to provide letters of credit or bank guarantees. Then, if the customer does not pay, the bank that provided the guarantee will do so. Particularly risky customers might be required to pay cash on delivery. For example, at one time retailer **Linens'n Things, Inc.** reported that its largest suppliers were requiring cash payment before delivery. The suppliers had cut off shipments because the company had been slow in paying. **Kmart's** suppliers also required it to pay cash in advance when it was financially troubled.

In addition, companies should ask potential customers for references from banks and suppliers, to determine their payment history. It is important to check references of potential new customers as well as periodically to check the financial health of continuing customers. Many resources are available for investigating customers. For example, *The Dun & Bradstreet Reference Book of American Business* (www.dnb.com) lists millions of companies and provides credit ratings for many of them.



Accounting Across the Organization: Bad Information Can Lead to Bad Loans

Many factors contributed to the recent credit crisis. One significant factor that resulted in many bad loans was a failure by lenders to investigate loan customers sufficiently. For example, Countrywide Financial Corporation wrote many loans under its “Fast and Easy” loan program. That program allowed borrowers to provide little or no documentation for their income or their assets. Other lenders had similar programs, which earned the nickname “liars’ loans.” One study found that in these situations, 60% of applicants overstated their incomes by more than 50% in order to qualify for a loan. Critics of the banking industry say that because loan officers were compensated for loan volume, and because banks were selling the loans to investors rather than holding them, the lenders had little incentive to investigate the borrowers’ creditworthiness.



©Andy Dean/iStockphoto

Source: Glenn R. Simpson and James R. Hagerty, “Countrywide Loss Focuses Attention on Underwriting,” *Wall Street Journal* (April 30, 2008), p. B1; and Michael Corkery, “Fraud Seen as Driver in Wave of Foreclosures,” *Wall Street Journal* (December 21, 2007), p. A1.



What steps should the banks have taken to ensure the accuracy of financial information provided on loan applications? (See [page 443](#).)

ESTABLISHING A PAYMENT PERIOD

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Companies that extend credit should determine a required payment period and communicate that policy to their customers. It is important that the payment period is consistent with that of competitors. For example, if you require payment within 15 days but your competitors allow payment within 45 days, you may lose sales to your competitors. To match your competitors' generous terms yet still encourage prompt payment of accounts, you might allow up to 45 days to pay but offer a sales discount for people paying within 15 days.

MONITORING COLLECTIONS

We discussed preparation of the accounts receivable aging schedule earlier in the chapter (pages 404–406). Companies should prepare an accounts receivable aging schedule at least monthly. In addition to estimating the allowance for doubtful accounts, the aging schedule has other uses. It helps managers estimate the timing of future cash inflows, which is very important to the treasurer's efforts to prepare a cash budget. It provides information about the overall collection experience of the company and identifies problem accounts. For example, management would compute and compare the percentage of receivables that are over 90 days past due. [Illustration 8-15](#) contains an excerpt from the notes to **Skechers**' financial statements discussing how it monitors receivables.

Illustration 8-15: Note on monitoring Skechers' receivables



SKECHERS USA

Notes to the Financial Statements

To minimize the likelihood of uncollectibility, customers' credit-worthiness is reviewed periodically based on external credit reporting services, financial statements issued by the customer and our experience with the account, and it is adjusted accordingly. When a customer's account becomes significantly past due, we generally place a hold on the account and discontinue further shipments to that customer, minimizing further risk of loss.

The aging schedule identifies problem accounts that the company needs to pursue with phone calls, letters, and occasionally legal action. Sometimes, special arrangements must be made with problem accounts. For example, it was reported that **Intel Corporation** (a major manufacturer of computer chips) required that **Packard Bell** (at one time one of the largest U.S. sellers of personal computers) exchange its past-due account receivable for an interest-bearing note receivable. This caused concern within the investment community. The move suggested that Packard Bell was in trouble, which worried Intel investors concerned about Intel's accounts receivable.



DECISION TOOLKIT

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
Is the company's credit risk increasing?	Customer account balances and due dates	Accounts receivable aging schedule	Compute and compare the percentage of receivables over 90 days old.
If a company has significant concentrations of credit risk, it must discuss this risk in the notes to its financial statements. A concentration of credit risk is a threat of nonpayment from a single large customer or class of customers that could adversely affect the financial health of the company. Illustration 8-16 shows an excerpt from the credit risk note from the 2011 annual report of Skechers . Skechers reports that its five largest customers account for 17.8% of its net sales, and two of its customers account for 22.5% of its receivables.			

Illustration 8-16: Excerpt from Skechers' note on concentration of credit risk



SKECHERS USA

Notes to the Financial Statements

We Depend Upon a Relatively Small Group of Customers for a Large Portion of Our Sales.

During 2011, 2010 and 2009, our net sales to our five largest customers accounted for approximately 17.8%, 24.0% and 25.1% of total net sales, respectively. No customer accounted for more than 10.0% of our net sales during 2011, 2010 and 2009. One customer accounted for 12.5% and another accounted for 10.0% of net trade receivables at December 31, 2011. No customer accounted for more than 10% of net trade receivables at December 31, 2010. If we lose a major customer, experience a significant decrease in sales to a major customer or are unable to collect the accounts receivable of a major customer, our business could be harmed.

This note to Skechers’ financial statements indicates it has a relatively high concentration of credit risk. A default by any of these large customers could have a significant negative impact on its financial performance.



DECISION TOOLKIT

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
Does the company have significant concentrations of credit risk?	Note to the financial statements on concentrations of credit risk	If risky credit customers are identified, the financial health of those customers should be evaluated to gain an independent assessment of the potential for a material credit loss.	If a material loss appears likely, the potential negative impact of that loss on the company should be carefully evaluated, along with the adequacy of the allowance for doubtful accounts.

EVALUATING LIQUIDITY OF RECEIVABLES

LEARNING OBJECTIVE 8

Identify ratios to analyze a company's receivables.

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Investors and managers keep a watchful eye on the relationship among sales, accounts receivable, and cash collections. If sales increase, then accounts receivable are also expected to increase. But a disproportionate increase in accounts receivable might signal trouble. Perhaps the company increased its sales by loosening its credit policy, and these receivables may be difficult or impossible to collect. Such receivables are considered less liquid. Recall that liquidity is measured by how quickly certain assets can be converted to cash.

The ratio that analysts use to assess the liquidity of receivables is the [accounts receivable turnover](#), computed by dividing net credit sales (net sales less cash sales) by the average net accounts receivable during the year. This ratio measures the number of times, on average, a company collects receivables during the period. Unless seasonal factors are significant, **average** accounts receivable outstanding can be computed from the beginning and ending balances of the net receivables.¹

A popular variant of the accounts receivable turnover is the [average collection period](#), which measures the average amount of time that a receivable is outstanding. This is done by dividing the accounts receivable turnover into 365 days. Companies use the average collection period to assess the effectiveness of a company's credit and collection policies. The average collection period should not greatly exceed the credit term period (i.e., the time allowed for payment).

The following data (in millions) are available for Nike.

For the year ended March 31,

	2011	2010
Sales	\$20,862	\$19,014
Accounts receivable (net)	3,138	2,650

[Illustration 8-17](#) (page 416) shows the accounts receivable turnover and average collection period for Nike and Skechers, along with comparative industry data. These calculations assume that all sales were credit sales.

Illustration 8-17: Accounts receivable turnover and average collection period

$$\text{Accounts Receivable Turnover} = \frac{\text{Net Credit Sales}}{\text{Average Net Accounts Receivable}}$$

$$\text{Average Collection Period} = \frac{365}{\text{Accounts Receivable Turnover}}$$

Ratio	Nike	Skechers USA	Industry Average
	(\$ in millions)		

Accounts receivable turnover $\frac{\$ 20,862}{(\$ 3,138 + \$ 2,650) / 2} = 7.2 \text{ times}$ 6.9 times 7.3 times 12.2 times

Average collection period $\frac{365 \text{ days}}{7.2} = 50.7 \text{ days}$ 52.9 days 50.0 days 29.9 days

Nike’s accounts receivable turnover was 7.2 times in 2011, with a corresponding average collection period of 50.7 days. This was slightly faster than its 2010 collection period. It was slower than the industry average collection period of 29.9 days and slightly higher than Skechers, which was 50 days. What this means is that Nike turned its receivables into cash more slowly than most other companies in its industry. Therefore, it was less likely to pay its current obligations than a company with a quicker accounts receivable turnover (all else equal) and is more likely to need outside financing to meet cash shortfalls.



DECISION TOOLKIT

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
----------------------	--------------------------	--------------------------	-------------------------

Are collections being made in a timely fashion?

Net credit sales and average net accounts receivable balance

$$\text{Accounts receivable turnover} = \frac{\text{Net credit sales}}{\text{Average net accounts receivable}}$$

Average collection period should be consistent with corporate credit policy. An increase may suggest a decline in financial health of customers.

$$\text{Average collection period} = \frac{365 \text{ days}}{\text{Accounts receivable turnover}}$$

In some cases, accounts receivable turnover may be misleading. Some large retail chains that issue their own credit cards encourage customers to use these cards for purchases. If customers pay slowly, the stores earn a healthy return on the outstanding receivables in the form of interest at rates of 18% to 22%. On the other hand, companies that sell (factor) their receivables on a consistent basis will have a faster turnover than those that do not. Thus, to interpret accounts receivable turnover, you must know how a company manages its receivables. In general, the faster the turnover, the greater the reliability of the current ratio for assessing liquidity.



ANALYSIS OF RECEIVABLES

In 2014, Lebron James Company had net credit sales of \$923,795 for the year. It had a beginning accounts receivable (net) balance of \$38,275 and an ending accounts receivable (net) balance of \$35,988. Compute Lebron James Company's (a) accounts receivable turnover and (b) average collection period in days.

Action Plan

- Review the formula to compute the accounts receivable turnover.
- Make sure that both the beginning and ending accounts receivable are considered in the computation.
- Review the formula to compute the average collection period in days.

Solution

- (a)
$$\begin{array}{rclcl} \text{Net credit sales} & \div & \text{Average net accounts receivable} & = & \text{Accounts receivable turnover} \\ \$ 923,795 & \div & \frac{\$ 38,275 + \$ 35,988}{2} & = & 24.9 \text{ times} \end{array}$$
- (b)
$$\begin{array}{rclcl} \text{Days in year} & \div & \text{Accounts receivable turnover} & = & \text{Average collection period in days} \\ 365 & \div & 24.9 \text{ times} & = & 14.7 \text{ days} \end{array}$$



Related exercise material: [BE8-10](#), [8-3](#), [E8-11](#), and [E8-12](#).



ACCELERATING CASH RECEIPTS

LEARNING OBJECTIVE 9

Describe methods to accelerate the receipt of cash from receivables.

In the normal course of events, companies collect accounts receivable in cash and remove them from the books. However, as credit sales and receivables have grown in size and significance, the “normal course of events” has changed. Two common expressions apply to the collection of receivables: (1) “Time is money”—that is, waiting for the normal collection process costs money. (2) “A bird in the hand is worth two in the bush”—that is, getting the cash now is better than getting it later or not at all. Therefore, in order to accelerate the receipt of cash from receivables, companies frequently sell their receivables to another company for cash, thereby shortening the cash-to-cash operating cycle.

There are three reasons for the sale of receivables. The first is their **size**. In recent years, for competitive reasons, sellers (retailers, wholesalers, and manufacturers) often have provided financing to purchasers of their goods. For example, many major companies in the automobile, truck, industrial and farm equipment, computer, and appliance industries have created companies that accept responsibility for accounts receivable financing. **Caterpillar** has **Caterpillar Financial Services**, **General Electric** has **GE Capital**, and **Ford** has **Ford Motor Credit Corp. (FMCC)**. These companies are referred to as **captive finance companies** because they are owned by the company selling the product. The purpose of captive finance companies is to encourage the sale of the company’s products by assuring financing to buyers. However, the parent companies involved do not necessarily want to hold large amounts of receivables, so they may sell them.

Second, **companies may sell receivables because they may be the only reasonable source of cash**. When credit is tight, companies may not be able to borrow money in the usual credit markets. Even if credit is available, the cost of borrowing may be prohibitive.

A final reason for selling receivables is that **billing and collection are often time-consuming and costly**. As a result, it is often easier for a retailer to sell the receivables to another party that has expertise in billing and collection matters. Credit card companies such as **MasterCard**, **Visa**, **American Express**, and **Discover** specialize in billing and collecting accounts receivable.

Sale of Receivables to a Factor

A common way to accelerate receivables collection is a sale to a factor. A **factor** is a finance company or bank that buys receivables from businesses for a fee and then collects the payments directly from the customers.

Factoring was traditionally associated with the textiles, apparel, footwear, furniture, and home furnishing industries. It has now spread to other types of businesses and is a multibillion dollar industry. For example, **Sears, Roebuck & Co.** (now **Sears Holdings**) once sold \$14.8 billion of customer accounts receivable. **McKesson** has a pre-arranged agreement allowing it to sell up to \$700 million of its receivables.

International Note

GAAP has less stringent requirements regarding the sale of receivables. Thus, GAAP companies can more easily use factoring transactions as a form of financing without showing a related liability on their books. Some argue that this

type of so-called “off-balance-sheet financing” would be more difficult to achieve under IFRS.

PRINTED BY: jromero0950@email.phoenix.edu. Printing is for personal, private use only. No part of this book may be reproduced or transmitted without publisher's prior permission. Violators will be prosecuted. Factoring arrangements vary widely, but typically the factor charges a commission. It ranges from 1% to 3% of the amount of receivables purchased. To illustrate, assume that Hendredon Furniture factors \$600,000 of receivables to Federal Factors, Inc. Federal Factors assesses a service charge of 2% of the amount of receivables sold. The following journal entry records Hendredon’s sale of receivables on April 2, 2014.

Apr. 2 Cash	588,000	
Service Charge Expense (2 % × \$ 600,000)	12,000	
Accounts Receivable		600,000

(To record the sale of accounts receivable)

A	=	L	+	SE
+588,000				
		-12,000 Exp		
-600,000				
Cash Flows				
+588,000				
				

If the company usually sells its receivables, it records the service charge expense as a selling expense. If the company sells receivables infrequently, it may report this amount under “Other expenses and losses” in the income statement.



Accounting Across the Organization: eBay for Receivables

The credit crunch has hit small businesses especially hard. Because banks have been very reluctant to loan, entrepreneurs have had to look more frequently to factoring as a source of cash. This created an opportunity for a new business called **The Receivables Exchange**. It offers a website where small companies can anonymously display a list of their receivables that they would like to factor in exchange for cash. Parties that are interested in providing cash in exchange for the receivables can also view the receivables and bid on those they like without revealing their identity. It has been described as “eBay for receivables.” Because of his continued use of the service, one experienced participant has reduced the monthly rate that he pays to The Receivables Exchange from 4% to below 3%.



© Emrah Turudu/iStockphoto

Source: Simona Covell, “Getting Your Due,” *Wall Street Journal Online* (May 11, 2009).



What issues should management consider in deciding whether to factor its receivables? (See [page 444](#).)

National Credit Card Sales

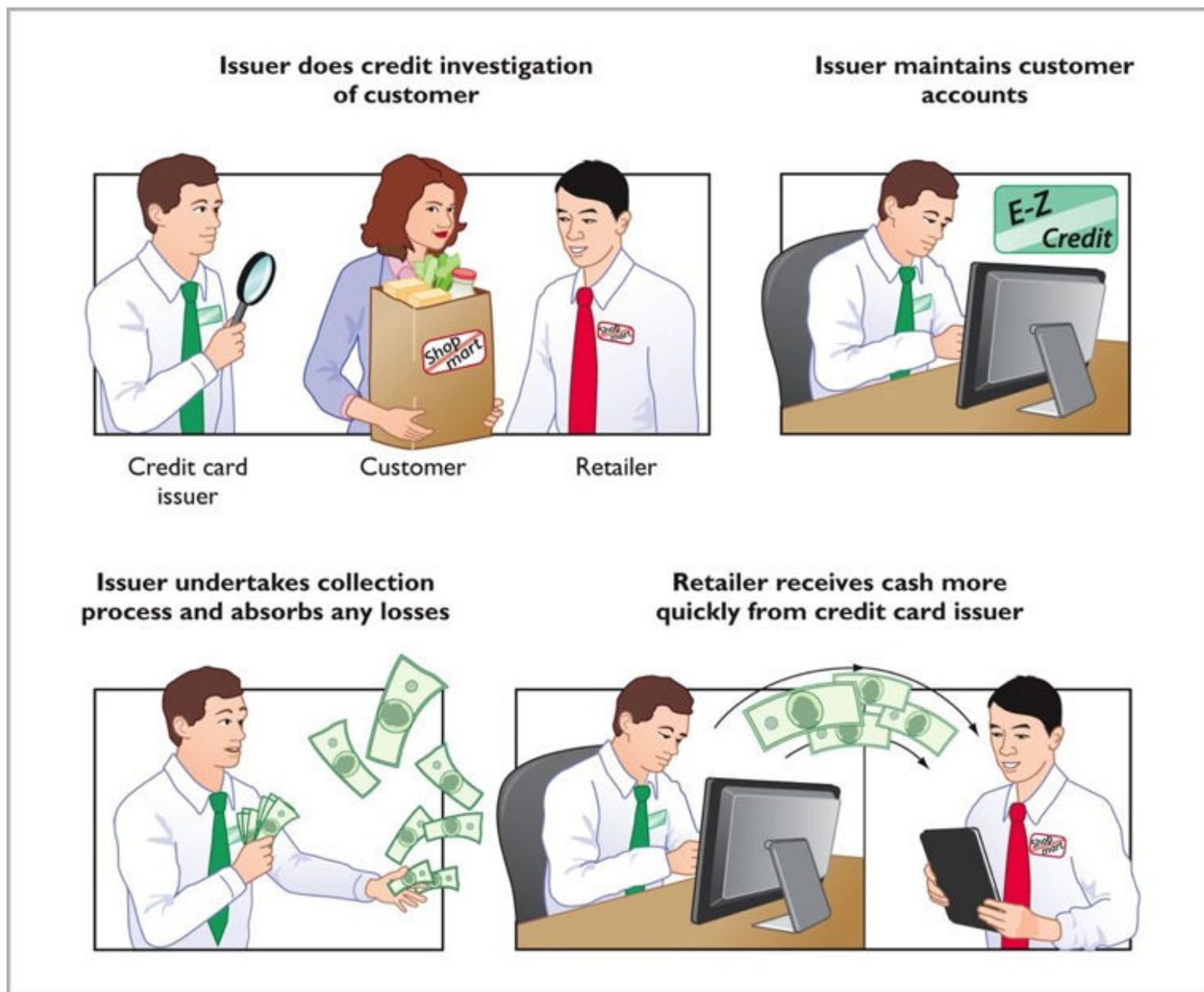
Approximately one billion credit cards were in use recently—more than three credit cards for every man, woman, and child in this country. A common type of credit card is a national credit card such as **Visa** and **MasterCard**. Three parties are involved when national credit cards are used in making retail sales: (1) the credit card issuer, who is independent of the retailer; (2) the retailer; and (3) the customer. **A retailer’s acceptance of a national credit card is another form of selling—factoring—the receivable by the retailer.**

The use of national credit cards translates to more sales and zero bad debts for the retailer. Both are powerful reasons for a retailer to accept such cards. [Illustration 8-18](#) shows the major advantages of national credit cards to the retailer.

Ethics Note

In exchange for lower interest rates, some companies have eliminated the 25-day grace period before finance charges kick in. Be sure you read the fine print in any credit agreement you sign.

Illustration 8-18: Advantages of credit cards to the retailer



The retailer considers sales resulting from the use of Visa and MasterCard as **cash sales**. Upon notification of a credit card charge from a retailer, the bank that issued the card immediately adds the amount to the seller's bank balance. Companies therefore record these credit card charges in the same manner as checks deposited from a cash sale.

To illustrate, Morgan Marie purchases \$1,000 of compact discs for her restaurant from Sondgeroth Music Co., and she charges this amount on her Visa First Bank Card. The service fee that First Bank charges Sondgeroth Music is 3%. Sondgeroth Music's entry to record this transaction on March 22, 2014, is:

Service Charge Expense	30
Sales Revenue	1,000

(To record Visa credit card sales)

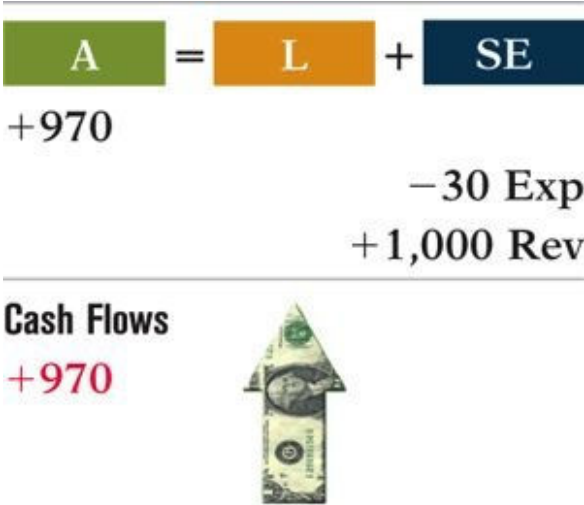
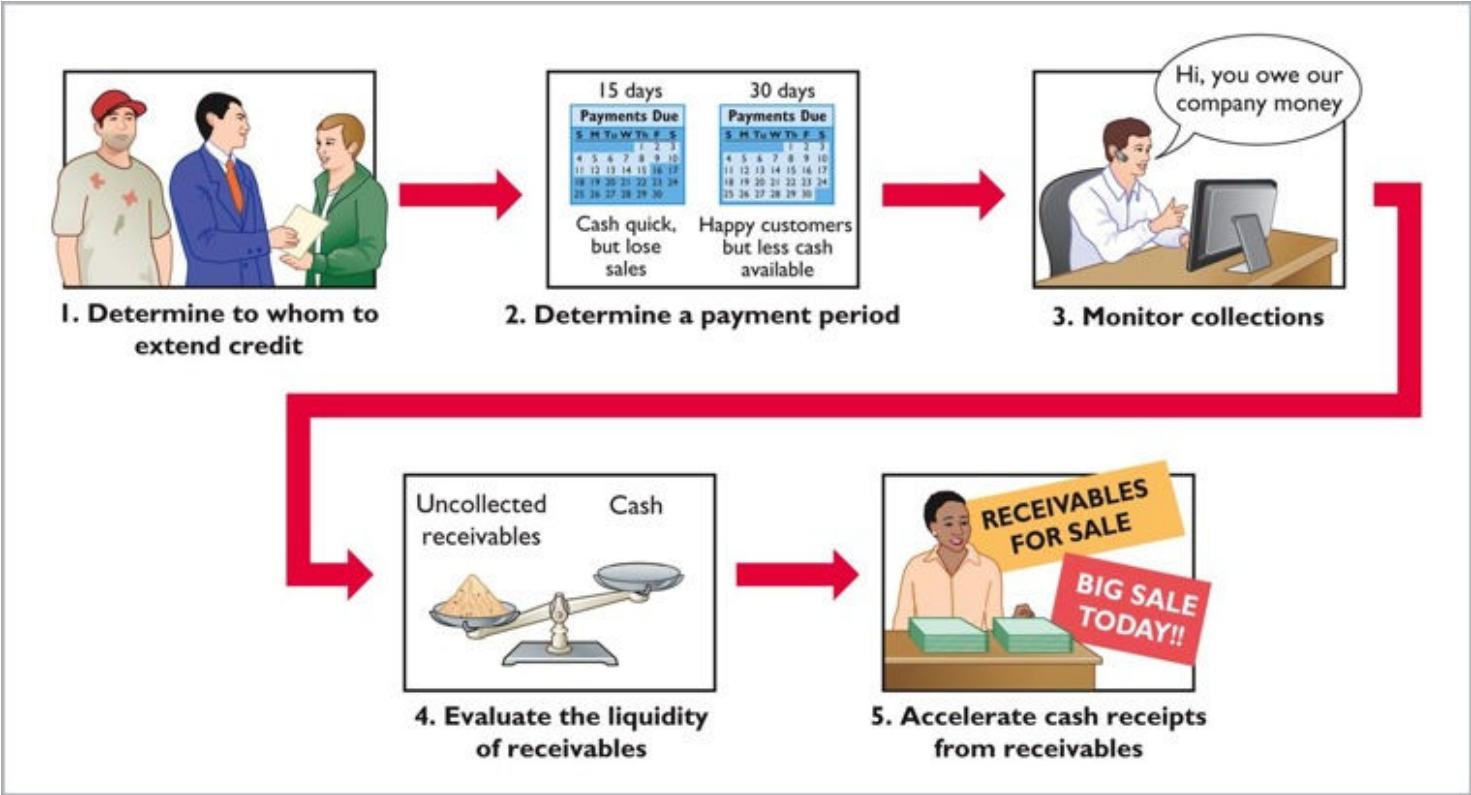


Illustration 8-19 (page 420) summarizes the basic principles of managing accounts receivable.

Illustration 8-19: Managing receivables





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FACTORING

Peter M. Kell Wholesalers Co. needs to raise \$120,000 in cash to safely cover next Friday's employee payroll. Kell has reached its debt ceiling. Kell's present balance of outstanding receivables totals \$750,000. Kell decides to factor \$125,000 of its receivables on September 7, 2014, to alleviate this cash crunch. Record the entry that Kell would make when it raises the needed cash. (Assume a 1% service charge.)

Action Plan

- Consider sale of receivables to a factor.
- Weigh cost of factoring against benefit of having cash in hand.

Solution

Assuming that Kell Co. factors \$125,000 of its accounts receivable at a 1% service charge, it would make this entry:

Sept. 7 Cash	123,750
Service Charge Expense (1 % × \$ 125,000)	1,250
Accounts Receivable	125,000

(To record sale of receivables to factor)

Related exercise material: [BE8-11](#),  [8-4](#), [E8-13](#), and [E8-14](#).



KEEPING AN EYE ON CASH

A lot of companies report strong sales growth but have cash flow problems. How can this be? The reason for the difference is timing: Sales revenue is recorded when goods are delivered even if cash is not received until later. For example, Nike had sales of \$20,862 million during 2011. Does that mean it received cash of \$20,862 million from its customers? Most likely not. So how do we determine the amount of cash related to sales revenue that is actually received from customers? We analyze the changes that take place in Accounts Receivable.

To illustrate, suppose Bestor Corporation started the year with \$10,000 in accounts receivable. During the year, it had credit sales of \$100,000. At the end of the year, the balance in accounts receivable was \$25,000. As a result, accounts receivable increased \$15,000 during the year. How much cash did Bestor collect from customers during the year? Using the following T-account, we can determine that collections were \$85,000.

Accounts Receivable

Beginning balance 10,000 85,000 Collections

Sales 100,000

Ending balance 25,000

As shown, the difference between sales and cash collections is explained by the change in Accounts Receivable. Accounts Receivable increased by \$15,000. Therefore, since credit sales were \$100,000, cash collections were only \$85,000.

To illustrate another situation, let's use Nike (see data on [page 415](#)). Recall that it had credit sales of \$20,862 million. Its ending receivables balance was \$3,138 million, and its beginning receivables balance was \$2,650 million—an increase of \$488 million. Given this change, we can determine that the cash collected from customers during the year was \$ 20,374 million (\$ 20,862 – \$ 488). This is shown in the following T-account.

Accounts Receivable

Beginning balance 2,650 20,374 Collections

Sales 20,862

Ending balance 3,138



USING

THE DECISION TOOLKIT

The information below was taken from the 2011 financial statements of **adidas**. Similar to **Nike** and **Skechers**, adidas sells shoes as well as other products.

Instructions

Comment on adidas' accounts receivable management and liquidity relative to that of Nike, using (1) the current ratio and (2) the accounts receivable turnover and average collection period. Nike's current ratio was 2.85:1. The other ratio values for Nike were calculated earlier in the chapter ([page 416](#)).



ADIDAS AG

Selected Financial Information (in millions)

	2011	2010
Sales	\$13,344	\$11,990
Current assets		
Cash and cash equivalents	\$ 906	\$ 1,156



ADIDAS AG

Selected Financial Information (in millions)

	2011	2010
Short-term investment securities	465	233
Accounts receivable (net)	1,707	1,667
Merchandise inventories	2,482	2,119
Other	<u>875</u>	<u>705</u>
Total current assets	\$6,435	\$5,880
Total current liabilities	\$4,281	\$3,908

Solution

- 1. Here is the 2011 current ratio (Current assets ÷ Current liabilities) for each company.

Nike adidas

$$2.85:1 \quad \frac{\$6,435}{\$4,281} = 1.50 : 1$$

Nike's current ratio far exceeds that of adidas. In fact, Nike's might be excessive. A company of its size would not normally want to have so much capital tied up in current assets.

- 2. The accounts receivable turnover and average collection period for each company are:

Nike adidas

$$\text{Accounts receivable turnover} \quad 7.2 \text{ times} \quad \frac{\$13,344}{(\$1,707 + \$1,667) / 2} = 7.9 \text{ times}$$

	Nike	adidas
Average collection period	50.7 days	$\frac{365}{7.9} = 46.2$ days

adidas' accounts receivable turnover of 7.9 compared to Nike's 7.2, and its average collection period of 46.2 days versus Nike's 50.7 days, suggest that adidas is able to collect from its customers slightly more quickly. It is important to note, however, that adidas is a German corporation. It reports under IFRS. A thorough comparison of adidas and Nike would require consideration of differences in the treatment of accounts receivable under IFRS and GAAP.



Summary of Learning Objectives

- **1 Identify the different types of receivables.** Receivables are frequently classified as accounts, notes, and other. Accounts receivable are amounts customers owe on account. Notes receivable represent claims that are evidenced by formal instruments of credit. Other receivables include nontrade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable.
- **2 Explain how accounts receivable are recognized in the accounts.** Companies record accounts receivable when they perform a service on account or at the point-of-sale of merchandise on account. Sales returns and allowances, and cash discounts reduce the amount received on accounts receivable.
- **3 Describe the methods used to account for bad debts.** The two methods of accounting for uncollectible accounts are the allowance method and the direct write-off method. Under the allowance method, companies estimate uncollectible accounts as a percentage of receivables. It emphasizes the cash realizable value of the accounts receivable. An aging schedule is frequently used with this approach.
- **4 Compute the interest on notes receivable.** The formula for computing interest is:
Face value of note $\times$ Annual interest rate $\times$ Time in terms of one year.
- **5 Describe the entries to record the disposition of notes receivable.** Notes can be held to maturity, at which time the borrower (maker) pays the face value plus accrued interest and the payee removes the note from the accounts. In many cases, however, similar to accounts receivable, the holder of the note speeds up the conversion by selling the receivable to another party. In some situations, the maker of the note dishonors the note (defaults), and the note is written off.
- **6 Explain the statement presentation of receivables.** Companies should identify each major type of receivable in the balance sheet or in the notes to the financial statements. Short-term receivables are considered current assets. Companies report the gross amount of receivables and allowance for doubtful accounts. They report bad debt and service charge expenses in the income statement as operating (selling) expenses, and interest revenue as other revenues and gains in the nonoperating section of the statement.
- **7 Describe the principles of sound accounts receivable management.** To properly manage receivables, management must (a) determine to whom to extend credit, (b) establish a payment period, (c) monitor collections, (d) evaluate the liquidity of receivables, and (e) accelerate cash receipts from receivables when necessary.
- **8 Identify ratios to analyze a company's receivables.** The accounts receivable turnover and the average collection period both are useful in analyzing management's effectiveness in managing receivables. The accounts receivable aging schedule also provides useful information.



DECISION TOOLKIT *A SUMMARY*

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
Is the amount of past due accounts increasing? Which accounts require management's attention?	List of outstanding receivables and their due dates	Prepare an aging schedule showing the receivables in various stages: outstanding 0–30 days, 31–60 days, 61–90 days, and over 90 days.	Accounts in the older categories require follow-up: letters, phone calls, and possible renegotiation of terms.

DECISION CHECKPOINTS	INFO NEEDED FOR DECISION	TOOL TO USE FOR DECISION	HOW TO EVALUATE RESULTS
Is the company's credit risk increasing?	Customer account balances and due dates	Accounts receivable aging schedule	Compute and compare the percentage of receivables over 90 days old.
Does the company have significant concentrations of credit risk?	Note to the financial statements on concentrations of credit risk	If risky credit customers are identified, the financial health of those customers should be evaluated to gain an independent assessment of the potential for a material credit loss.	If a material loss appears likely, the potential negative impact of that loss on the company should be carefully evaluated, along with the adequacy of the allowance for doubtful accounts.
Are collections being made in a timely fashion?	Net credit sales and average net receivables balance	$\text{Accounts receivable turnover} = \frac{\text{Net credit sales}}{\text{Average net accounts receivable}}$ $\text{Average collection period} = \frac{365 \text{ days}}{\text{Accounts receivable turnover}}$	Average collection period should be consistent with corporate credit policy. An increase may suggest a decline in financial health of customers.

Glossary

Accounts receivable

(p. 399) Amounts customers owe on account.

Accounts receivable turnover

(p. 415) A measure of the liquidity of accounts receivable, computed by dividing net credit sales by average net accounts receivable.

Aging the accounts receivable

(p. 405) A schedule of customer balances classified by the length of time they have been unpaid.

Allowance method

Average collection period

(p. 415) The average amount of time that a receivable is outstanding, calculated by dividing 365 days by the accounts receivable turnover.

Bad Debt Expense

(p. 401) An expense account to record losses from extending credit.

Cash (net) realizable value

(p. 402) The net amount a company expects to receive in cash from receivables.

Concentration of credit risk

(p. 414) The threat of nonpayment from a single large customer or class of customers that could adversely affect the financial health of the company.

Direct write-off method

(p. 401) A method of accounting for bad debts that involves charging receivable balances to Bad Debt Expense at the time receivables from a particular company are determined to be uncollectible.

Dishonored (defaulted) note

(p. 411) A note that is not paid in full at maturity.

Factor

(p. 418) A finance company or bank that buys receivables from businesses for a fee and then collects the payments directly from the customers.

Maker

(p. 407) The party in a promissory note who is making the promise to pay.

Notes receivable

(p. 399) Written promise (as evidenced by a formal instrument) for amounts to be received.

Payee

(p. 407) The party to whom payment of a promissory note is to be made.

Percentage-of-receivables basis

(p. 404) A method of estimating the amount of bad debt expense whereby management establishes a percentage relationship between the amount of receivables and the expected losses from uncollectible accounts.

Promissory note

(p. 407) A written promise to pay a specified amount of money on demand or at a definite time.

Receivables

(p. 398) Amounts due from individuals and companies that are expected to be collected in cash.



Comprehensive

Presented here are selected transactions related to B. Dylan Corp.

Mar. 1 Sold \$20,000 of merchandise to Potter Company, terms 2/10, n/30.

11 Received payment in full from Potter Company for balance due on existing accounts receivable.

12 Accepted Juno Company's \$20,000, 6-month, 12% note for balance due on outstanding account receivable.

13 Made B. Dylan Corp. credit card sales for \$13,200.

15 Made Visa credit sales totaling \$6,700. A 5% service fee is charged by Visa.

Apr. 11 Sold accounts receivable of \$8,000 to Harcot Factor. Harcot Factor assesses a service charge of 2% of the amount of receivables sold.

13 Received collections of \$8,200 on B. Dylan Corp. credit card sales.

May 10 Wrote off as uncollectible \$16,000 of accounts receivable. (B. Dylan Corp. uses the percentage-of-receivables basis to estimate bad debts.)

June 30 The balance in accounts receivable at the end of the first 6 months is \$200,000. The company estimates that 10% of accounts receivable will become uncollectible. At June 30 the credit balance in the allowance account prior to adjustment is \$3,500. Recorded bad debt expense.

July 16 One of the accounts receivable written off in May pays the amount due, \$4,000, in full.

Instructions

Prepare the journal entries for the transactions. (Omit cost of goods sold entries.)

Action Plan

- Generally, record accounts receivable at invoice price.
- Recognize that sales returns and allowances and cash discounts reduce the amount received on accounts receivable.
- Record a service charge expense on the seller's books when accounts receivable are sold.
- Prepare an adjusting entry for bad debt expense.

Solution to Comprehensive

Mar. 1	Accounts Receivable—Potter Company	20,000	
	Sales Revenue		20,000
	(To record sales on account)		
11	Cash	19,600	
	Sales Discounts (2 % × \$ 20,000)	400	
	Accounts Receivable—Potter Company	20,000	
	(To record collection of accounts receivable)		
12	Notes Receivable	20,000	
	Accounts Receivable—Juno Company	20,000	
	(To record acceptance of Juno Company note)		
13	Accounts Receivable	13,200	
	Sales Revenue		13,200
	(To record company credit card sales)		
15	Cash	6,365	
	Service Charge Expense (5 % × \$ 6,700)	335	
	Sales Revenue		6,700

Apr. 11	Cash	7,840
	Service Charge Expense $(2 \% \times \$ 8,000)$	160
	Accounts Receivable	8,000
	(To record sale of receivables to factor)	
13	Cash	8,200
	Accounts Receivable	8,200
	(To record collection of accounts receivable)	
May 10	Allowance for Doubtful Accounts	16,000
	Accounts Receivable	16,000
	(To record write-off of accounts receivable)	
June 30	Bad Debt Expense	16,500
	Allowance for Doubtful Accounts	16,500
	$[(\$ 200,000 \times 10 \%) - \$ 3,500]$	
	(To record estimate of uncollectible accounts)	
July 16	Accounts Receivable	4,000
	Allowance for Doubtful Accounts	4,000
	(To reverse write-off of accounts receivable)	
	Cash	4,000

(To record collection of accounts receivable)

*

Cost of goods sold entries are omitted here as well as in homework material.



- Self-Test, Brief Exercises, Exercises, Problem Set A, and many more resources are available for practice in WileyPLUS.

Self-Test Questions

Answers are on [page 444](#).

1.

A receivable that is evidenced by a formal instrument and that normally requires the payment of interest is:

(LO 1)

- (a) an account receivable.
- (b) a trade receivable.
- (c) a note receivable.
- (d) a classified receivable.

2.

Kersee Company on June 15 sells merchandise on account to Soo Eng Co. for \$1,000, terms 2/10, n/30. On June 20, Eng Co. returns merchandise worth \$300 to Kersee Company. On June 24, payment is received from Eng Co. for the balance due. What is the amount of cash received?

(LO 2)

- (a) \$700.
- (b) \$680.
- (c) \$686.
- (d) None of the above.

3.

Accounts and notes receivable are reported in the current assets section of the balance sheet at:

(LO 3, 6)

4.

Net credit sales for the month are \$800,000. The accounts receivable balance is \$160,000. The allowance is calculated as 7.5% of the receivables balance using the percentage-of-receivables basis. If Allowance for Doubtful Accounts has a credit balance of \$5,000 before adjustment, what is the balance after adjustment?

(LO 3)

- (a) \$12,000.
- (b) \$7,000.
- (c) \$17,000.
- (d) \$31,000.

5.

In 2014, Patterson Wholesale Company had net credit sales of \$750,000. On January 1, 2014, Allowance for Doubtful Accounts had a credit balance of \$18,000. During 2014, \$30,000 of uncollectible accounts receivable were written off. Past experience indicates that the allowance should be 10% of the balance in receivables (percentage-of-receivables basis). If the accounts receivable balance at December 31 was \$200,000, what is the required adjustment to Allowance for Doubtful Accounts at December 31, 2014?

(LO 3)

- (a) \$20,000.
- (b) \$75,000.
- (c) \$32,000.
- (d) \$30,000.

6.

An analysis and aging of the accounts receivable of Raja Company at December 31 reveal these data:

(LO 3)

Accounts receivable	\$800,000
Allowance for doubtful accounts per books before adjustment (credit)	50,000
Amounts expected to become uncollectible	65,000

What is the cash realizable value of the accounts receivable at December 31, after adjustment?

- (a) \$685,000.
- (b) \$750,000.
- (c) \$800,000.
- (d) \$735,000.

7.

Which of these statements about promissory notes is incorrect?

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(LO 4)

- (a) The party making the promise to pay is called the maker.
- (b) The party to whom payment is to be made is called the payee.
- (c) A promissory note is not a negotiable instrument.
- (d) A promissory note is more liquid than an account receivable.

8.

Michael Co. accepts a \$1,000, 3-month, 12% promissory note in settlement of an account with Tani Co. The entry to record this transaction is:

(LO 4)

(a) Notes Receivable	1,030
Accounts Receivable	1,030
(b) Notes Receivable	1,000
Accounts Receivable	1,000
(c) Notes Receivable	1,000
Sales Revenue	1,000
(d) Notes Receivable	1,020
Accounts Receivable	1,020

9.

Schleis Co. holds Murphy Inc.'s \$10,000, 120-day, 9% note. The entry made by Schleis Co. when the note is collected, assuming no interest has previously been accrued, is:

(LO 5)

(a) Cash	10,300
Notes Receivable	10,300
(b) Cash	10,000

(c) Accounts Receivable	10,300
Notes Receivable	10,000
Interest Revenue	300
(d) Cash	10,300
Notes Receivable	10,000
Interest Revenue	300

10.

If a company is concerned about extending credit to a risky customer, it could do any of the following **except**:

(LO 7)

- (a) require the customer to pay cash in advance.
- (b) require the customer to provide a letter of credit or a bank guarantee.
- (c) contact references provided by the customer, such as banks and other suppliers.
- (d) provide the customer a lengthy payment period to increase the chance of paying.

11.

 Eddy Corporation had net credit sales during the year of \$800,000 and cost of goods sold of \$500,000. The balance in receivables at the beginning of the year was \$100,000 and at the end of the year was \$150,000. What was the accounts receivable turnover?

(LO 8)

- (a) 6.4
- (b) 8.0
- (c) 5.3
- (d) 4.0

12.

 Prall Corporation sells its goods on terms of 2/10, n/30. It has an accounts receivable turnover of 7. What is its average collection period (days)?

(LO 8)

- (a) 2,555
- (b) 30
- (c) 52
- (d) 210

13. PRINTED BY: jromero0950@email.phoenix.edu. Printing is for personal, private use only. No part of this book may be reproduced or transmitted without publisher's prior permission. Violators will be prosecuted.
Which of these statements about **Visa** credit card sales is **incorrect**?

(LO 9)

- (a) The credit card issuer conducts the credit investigation of the customer.
- (b) The retailer is not involved in the collection process.
- (c) The retailer must wait to receive payment from the issuer.
- (d) The retailer receives cash more quickly than it would from individual customers.

14.

Good Stuff Retailers accepted \$50,000 of **Citibank Visa** credit card charges for merchandise sold on July 1. Citibank charges 4% for its credit card use. The entry to record this transaction by Good Stuff Retailers will include a credit to Sales Revenue of \$50,000 and a debit(s) to:

(LO 9)

- (a) Cash \$48,000 and Service Charge Expense \$2,000.
- (b) Accounts Receivable \$48,000 and Service Charge Expense \$2,000.
- (c) Cash \$50,000.
- (d) Accounts Receivable \$50,000.

15.

A company can accelerate its cash receipts by all of the following **except**:

(LO 9)

- (a) offering discounts for early payment.
- (b) accepting national credit cards for customer purchases.
- (c) selling receivables to a factor.
- (d) writing off receivables.

Go to the book's companion website, www.wiley.com/college/kimmel, to access additional Self-Test Questions.



Questions

1.

What is the difference between an account receivable and a note receivable?

2.

What are some common types of receivables other than accounts receivable or notes receivable?

3.

What are the essential features of the allowance method of accounting for bad debts?

4. PRINTED BY: jromero0950@email.phoenix.edu. Printing is for personal, private use only. No part of this book may be reproduced or transmitted without publisher's prior permission. Violators will be prosecuted. Mitch Lang cannot understand why the cash realizable value does not decrease when an uncollectible account is written off under the allowance method. Clarify this point for Mitch.

5.

Mendoza Company has a credit balance of \$2,200 in Allowance for Doubtful Accounts before adjustment. The estimated uncollectibles under the percentage-of-receivables basis is \$5,100. Prepare the adjusting entry.

6.



What types of receivables does **Tootsie Roll** report on its balance sheet? Does it use the allowance method or the direct write-off method to account for uncollectibles?

7.

How are bad debts accounted for under the direct write-off method? What are the disadvantages of this method?

8.



Debbie Trevino, the vice president of sales for Tropical Pools and Spas, wants the company's credit department to be less restrictive in granting credit. "How can we sell anything when you guys won't approve anybody?" she asks. Discuss the pros and cons of "easy credit." What are the accounting implications?

9.

Your roommate is uncertain about the advantages of a promissory note. Compare the advantages of a note receivable with those of an account receivable.

10.

How may the maturity date of a promissory note be stated?

11.

Compute the missing amounts for each of the following notes.

Principal	Annual Interest Rate	Time	Total Interest
(a)	6%	60 days	\$ 270
\$30,000	8%	3 years	(d)
\$60,000	(b)	5 months	\$2,500
\$50,000	11%	(c)	\$2,750

12.

13. General Motors Company has accounts receivable and notes receivable. How should the receivables be reported on the balance sheet?

14.



What are the steps to good receivables management?

15.



How might a company monitor the risk related to its accounts receivable?

16.



What is meant by a concentration of credit risk?

17.



The president of Dickerson Inc. proudly announces her company's improved liquidity since its current ratio has increased substantially from one year to the next. Does an increase in the current ratio always indicate improved liquidity? What other ratio or ratios might you review to determine whether or not the increase in the current ratio is an improvement in financial health?

18.



Since hiring a new sales director, Hilson Inc. has enjoyed a 50% increase in sales. The CEO has also noticed, however, that the company's average collection period has increased from 17 days to 38 days. What might be the cause of this increase? What are the implications to management of this increase?

19.



The Coca-Cola Company's accounts receivable turnover was 9.05 in 2011, and its average amount of net receivables during the period was \$3,424 million. What is the amount of its net credit sales for the period? What is the average collection period in days?

20.



JCPenney Company accepts both its own credit cards and national credit cards. What are the advantages of accepting both types of cards?

21.



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An article in the *Wall Street Journal* indicated that companies are selling their receivables at a record rate. Why do companies sell their receivables?

22.

Calico Corners decides to sell \$400,000 of its accounts receivable to Quick Central Factors Inc. Quick Central Factors assesses a service charge of 3% of the amount of receivables sold. Prepare the journal entry that Calico Corners makes to record this sale.

23.

Pine Corp. has experienced tremendous sales growth this year, but it is always short of cash. What is one explanation for this occurrence?

24.

How can the amount of collections from customers be determined?

Brief Exercises

BE8-1 Presented below are three receivables transactions. Indicate whether these receivables are reported as accounts receivable, notes receivable, or other receivables on a balance sheet.

Identify different types of receivables.

(LO 1), C

- (a) Advanced \$10,000 to an employee.
- (b) Received a promissory note of \$34,000 for services performed.
- (c) Sold merchandise on account for \$60,000 to a customer.

BE8-2 Record the following transactions on the books of Cohen Co. (Omit cost of goods sold entries.)

Record basic accounts receivable transactions.

(LO 2), AP

- (a) On July 1, Cohen Co. sold merchandise on account to Tracy Inc. for \$23,000, terms 2/10, n/30.
- (b) On July 8, Tracy Inc. returned merchandise worth \$2,400 to Cohen Co.
- (c) On July 11, Tracy Inc. paid for the merchandise.

BE8-3 At the end of 2013, Morley Co. has accounts receivable of \$700,000 and an allowance for doubtful accounts of \$25,000. On January 24, 2014, it is learned that the company's receivable from Spears Inc. is not collectible and therefore management authorizes a write-off of \$4,300.

Prepare entry for write-off, and determine cash realizable value.

(LO 3), AP

- (a) Prepare the journal entry to record the write-off.
- (b) What is the cash realizable value of the accounts receivable (1) before the write-off and (2) after the write-off?

BE8-4 Assume the same information as **BE8-3** and that on March 4, 2014, Morley Co. receives payment of \$4,300 in full from Spears Inc. Prepare the journal entries to record this transaction.

BE8-5 Hirdt Co. uses the percentage-of-receivables basis to record bad debt expense and concludes that 2% of accounts receivable will become uncollectible. Accounts receivable are \$400,000 at the end of the year, and the allowance for doubtful accounts has a credit balance of \$2,800.

Prepare entry using percentage-of-receivables method.

(LO 3), AP

- (a) Prepare the adjusting journal entry to record bad debt expense for the year.
- (b) If the allowance for doubtful accounts had a debit balance of \$900 instead of a credit balance of \$2,800, prepare the adjusting journal entry for bad debt expense.

BE8-6 Compute interest and find the maturity date for the following notes.

Compute interest and determine maturity dates on notes.

(LO 4), AP

Date of Note	Principal	Interest Rate (%)	Terms
(a) June 10	\$80,000	6%	60 days
(b) July 14	\$50,000	7%	90 days
(c) April 27	\$12,000	8%	75 days

BE8-7 Presented below are data on three promissory notes. Determine the missing amounts.

Determine maturity dates and compute interest and rates on notes.

(LO 4), AP

Date of Note	Terms	Maturity Date	Principal	Annual Interest Rate	Total Interest
(a) April 1	60 days	?	\$600,000	9%	?
(b) July 2	30 days	?	90,000	?	\$600
(c) March 7	6 months	?	120,000	10%	?

BE8-8 On January 10, 2014, Tolleson Co. sold merchandise on account to Simmons for \$8,000, terms n/30. On February 9, Simmons gave Tolleson Co. a 7% promissory note in settlement of this account. Prepare the journal entry

(LO 4), AP

BE8-9 During its first year of operations, Gehrig Company had credit sales of \$3,000,000, of which \$400,000 remained uncollected at year-end. The credit manager estimates that \$18,000 of these receivables will become uncollectible.

Prepare entry for estimated uncollectibles and classifications, and compute ratios.

(LO 3, 6, 7, 8), AP



- (a) Prepare the journal entry to record the estimated uncollectibles. (Assume an unadjusted balance of zero in Allowance for Doubtful Accounts.)
- (b) Prepare the current assets section of the balance sheet for Gehrig Company, assuming that in addition to the receivables it has cash of \$90,000, merchandise inventory of \$180,000, and supplies of \$13,000.
- (c) Calculate the accounts receivable turnover and average collection period. Assume that average net accounts receivable were \$300,000. Explain what these measures tell us.

BE8-10 Suppose the 2014 financial statements of **3M Company** report net sales of \$23.1 billion. Accounts receivable (net) are \$3.2 billion at the beginning of the year and \$3.25 billion at the end of the year. Compute 3M's accounts receivable turnover. Compute 3M's average collection period for accounts receivable in days.

Analyze accounts receivable.

(LO 8), AP



BE8-11 Consider these transactions:

Prepare entries for credit card sale and sale of accounts receivable.

(LO 9), AP

- (a) Draber Restaurant accepted a Visa card in payment of a \$200 lunch bill. The bank charges a 3% fee. What entry should Draber make?
- (b) Marin Company sold its accounts receivable of \$65,000. What entry should Marin make, given a service charge of 3% on the amount of receivables sold?

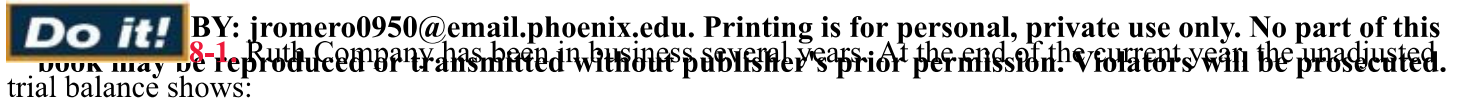
BE8-12 Richman Corp. had a beginning balance in accounts receivable of \$70,000 and an ending balance of \$91,000. Credit sales during the period were \$598,000. Determine cash collections.

Determine cash collections.

(LO 9), AP



Review

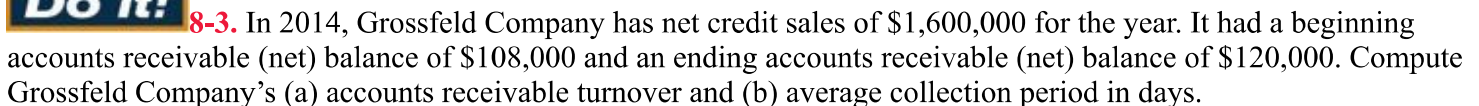


(LO 3), AP

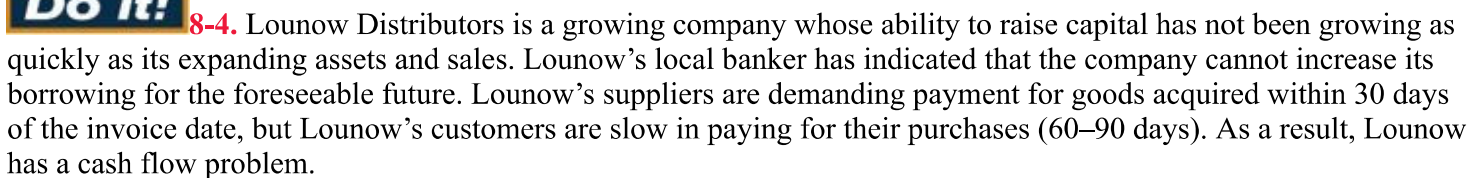
Allowance for Doubtful Accounts	5,700 Cr.
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Do It! 8-2. Berkman Wholesalers accepts from Almonte Stores a \$6,200, 4-month, 9% note dated May 31 in settlement of Almonte's overdue account. The maturity date of the note is September 30. What entry does Berkman make at the maturity date, assuming Almonte pays the note and interest in full at that time?

(LO 4, 5), AP



(LO 8), AP



(LO 9), AP

Lounow needs \$160,000 to cover next Friday's payroll. Its balance of outstanding accounts receivable totals \$800,000. To alleviate this cash crunch, the company sells \$170,000 of its receivables. Record the entry that Lounow would make. (Assume a 2% service charge.)

Exercises

Prepare entries for recognizing accounts receivable.

(LO 2), AP

Instructions

Prepare the entries on Aaron Co.'s books to record the sale and related collection. (Omit cost of goods sold entries.)

E8-2 On January 10, Allison Milo uses her Crawford Co. credit card to purchase merchandise from Crawford Co. for \$1,700. On February 10, Milo is billed for the amount due of \$1,700. On February 12, Milo pays \$1,100 on the balance due. On March 10, Milo is billed for the amount due, including interest at 1% per month on the unpaid balance as of February 12.

Prepare entries for recognizing accounts receivable.

(LO 2), AP

Instructions

Prepare the entries on Crawford Co.'s books related to the transactions that occurred on January 10, February 12, and March 10. (Omit cost of goods sold entries.)

E8-3 At the beginning of the current period, Griffey Corp. had balances in Accounts Receivable of \$200,000 and in Allowance for Doubtful Accounts of \$9,000 (credit). During the period, it had net credit sales of \$800,000 and collections of \$763,000. It wrote off as uncollectible accounts receivable of \$7,300. However, a \$3,100 account previously written off as uncollectible was recovered before the end of the current period. Uncollectible accounts are estimated to total \$25,000 at the end of the period. (Omit cost of goods sold entries.)

Journalize receivables transactions.

(LO 2, 3), AP

Instructions

- (a) Prepare the entries to record sales and collections during the period.
- (b) Prepare the entry to record the write-off of uncollectible accounts during the period.
- (c) Prepare the entries to record the recovery of the uncollectible account during the period.
- (d) Prepare the entry to record bad debt expense for the period.
- (e) Determine the ending balances in Accounts Receivable and Allowance for Doubtful Accounts.
- (f) What is the net realizable value of the receivables at the end of the period?

E8-4 The ledger of Wainwright Company at the end of the current year shows Accounts Receivable \$78,000; Credit Sales \$810,000; and Sales Returns and Allowances \$40,000.

Prepare entries to record allowance for doubtful accounts.

(LO 3), AP

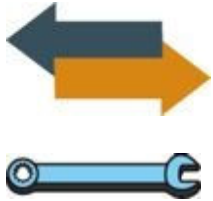
Instructions

- (a) If Wainwright uses the direct write-off method to account for uncollectible accounts, journalize the adjusting entry at December 31, assuming Wainwright determines that Hiller's \$900 balance is uncollectible.
- (b) If Allowance for Doubtful Accounts has a credit balance of \$1,100 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be 10% of accounts receivable.

E8-5 Stine Company has accounts receivable of \$95,400 at March 31, 2014. An analysis of the accounts shows these amounts.

Determine bad debt expense, and prepare the adjusting entry.

(LO 3), AP



	Balance, March 31	
Month of Sale	2014	2013
March	\$65,000	\$75,000
February	12,900	8,000
December and January	10,100	2,400
November and October	<u>7,400</u>	<u>1,100</u>
	\$95,400	\$86,500

Credit terms are 2/10, n/30. At March 31, 2014, there is a \$2,100 credit balance in Allowance for Doubtful Accounts prior to adjustment. The company uses the percentage-of-receivables basis for estimating uncollectible accounts. The company's estimates of bad debts are as shown below.

Age of Accounts	Estimated Percentage Uncollectible
Current	2%
1–30 days past due	5
31–90 days past due	30

Age of Accounts	Estimated Percentage Uncollectible
-----------------	------------------------------------

Over 90 days past due	50
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Instructions

- (a) Determine the total estimated uncollectibles.
- (b) Prepare the adjusting entry at March 31, 2014, to record bad debt expense.
- (c) Discuss the implications of the changes in the aging schedule from 2013 to 2014.

E8-6 On December 31, 2013, when its Allowance for Doubtful Accounts had a debit balance of \$1,400, Hunt Co. estimates that 9% of its accounts receivable balance of \$90,000 will become uncollectible and records the necessary adjustment to Allowance for Doubtful Accounts. On May 11, 2014, Hunt Co. determined that J. Byrd's account was uncollectible and wrote off \$1,200. On June 12, 2014, Byrd paid the amount previously written off.

Prepare entry for estimated uncollectibles, write-off, and recovery.

(LO 3), AP

Instructions

Prepare the journal entries on December 31, 2013, May 11, 2014, and June 12, 2014.

E8-7 Malone Supply Co. has the following transactions related to notes receivable during the last 2 months of the year. The company does not make entries to accrue interest except at December 31.

Prepare entries for notes receivable transactions.

(LO 4, 5), AP

Nov. 1 Loaned \$60,000 cash to B. Carr on a 12-month, 7% note.

Dec. 11 Sold goods to R. P. Kiner, Inc., receiving a \$3,600, 90-day, 8% note.

16 Received a \$12,000, 180-day, 9% note to settle an open account from M. Adcock.

31 Accrued interest revenue on all notes receivable.

Instructions

Journalize the transactions for Malone Supply Co. (Omit cost of goods sold entries.)

E8-8 These transactions took place for Glavine Co.

Journalize notes receivable transactions.

2013

May 1 Received a \$5,000, 12-month, 6% note in exchange for an outstanding account receivable from S. Rooney.

Dec. 31 Accrued interest revenue on the S. Rooney note.

2014

May 1 Received principal plus interest on the S. Rooney note. (No interest has been accrued since December 31, 2013.)

Instructions

Record the transactions in the general journal. The company does not make entries to accrue interest except at December 31.

E8-9 Shannon Corp. had the following balances in receivable accounts at October 31, 2014 (in thousands): Allowance for Doubtful Accounts \$52; Accounts Receivable \$2,910; Other Receivables \$189; Notes Receivable \$1,353.

Prepare a balance sheet presentation of receivables.

(LO 6), AP

Instructions

Prepare the balance sheet presentation of Shannon Corp.'s receivables in good form.

E8-10 The following is a list of activities that companies perform in relation to their receivables.

Identify the principles of receivables management.

(LO 7), K



- 1. Selling receivables to a factor.
- 2. Reviewing company ratings in *The Dun and Bradstreet Reference Book of American Business*.
- 3. Collecting information on competitors' payment period policies.
- 4. Preparing monthly accounts receivable aging schedule and investigating problem accounts.
- 5. Calculating the accounts receivable turnover and average collection period.

Instructions

Match each of the activities listed above with a purpose of the activity listed below.

- (a) Determine to whom to extend credit.
- (b) Establish a payment period.

- (c) Monitor collections.
- (d) Evaluate the liquidity of receivables.
- (e) Accelerate cash receipts from receivable when necessary.

E8-11 Suppose the following information was taken from the 2014 financial statements of **FedEx Corporation**, a major global transportation/delivery company.

Compute ratios to evaluate a company's receivables balance.

(LO 7, 8), AN

(in millions)	2014	2013
Accounts receivable (gross)	\$ 3,587	\$ 4,517
Accounts receivable (net)	3,391	4,359
Allowance for doubtful accounts	196	158
Sales revenue	35,497	37,953
Total current assets	7,116	7,244

Instructions

Answer each of the following questions.

- (a) Calculate the accounts receivable turnover and the average collection period for 2014 for FedEx.
- (b) Is accounts receivable a material component of the company's total current assets?
- (c) Evaluate the balance in FedEx's allowance for doubtful accounts.

E8-12 The following ratios are available for Lin Inc.

Evaluate liquidity.

(LO 7, 8, 9), AN



	2014	2013
Current ratio	1.3:1	1.5:1
Accounts receivable turnover	12 times	10 times

2014 2013

Inventory turnover 11 times 9 times

Instructions

- (a) Is Lin's short-term liquidity improving or deteriorating in 2014? Be specific in your answer, referring to relevant ratios.
- (b) Do changes in turnover ratios affect profitability? Explain.
- (c) Identify any steps Lin might have taken, or might wish to take, to improve its management of its accounts receivable and inventory turnovers.

E8-13 On March 3, Beachy Appliances sells \$710,000 of its receivables to National Factors Inc. National Factors Inc. assesses a service charge of 4% of the amount of receivables sold.

Prepare entry for sale of accounts receivable.

(LO 9), AP

Instructions

Prepare the entry on Beachy Appliances' books to record the sale of the receivables.

E8-14 In a recent annual report, **Office Depot, Inc.** notes that the company entered into an agreement to sell all of its credit card program receivables to financial service companies.

Identify reason for sale of receivables.

(LO 9), C



Instructions

Explain why Office Depot, a financially stable company with positive cash flow, would choose to sell its receivables.

E8-15 On May 10, Renn Company sold merchandise for \$4,000 and accepted the customer's First Business Bank MasterCard. At the end of the day, the First Business Bank MasterCard receipts were deposited in the company's bank account. First Business Bank charges a 3.8% service charge for credit card sales.

Prepare entry for credit card sale.

(LO 9), AP

Instructions

Prepare the entry on Renn Company's books to record the sale of merchandise.

E8-16 On July 4, Susie's Restaurant accepts a Visa card for a \$250 dinner bill. Visa charges a 4% service fee.

Instructions

Prepare the entry on Susie's books related to the transaction.

E8-17 Kimbrel Corp. significantly reduced its requirements for credit sales. As a result, sales during the current year increased dramatically. It had receivables at the beginning of the year of \$38,000 and ending receivables of \$191,000. Credit sales were \$380,000.

Determine cash flows and evaluate quality of earnings.

(LO 9), AN

Instructions

- (a) Determine cash collections during the period.
- (b) Discuss how your findings in part (a) would affect Kimbrel Corp.'s quality of earnings ratio. (Do not compute.)
- (c) What concerns might you have regarding Kimbrel's accounting?

Exercises: Set B and Challenge Exercises

Visit the book's companion website, at www.wiley.com/college/kimmel, and choose the Student Companion site to access Exercise Set B and Challenge Exercises.

Problems: Set A

P8-1A Reynolds.com uses the allowance method of accounting for bad debts. The company produced the following aging of the accounts receivable at year-end.

Journalize transactions related to bad debts.

(LO 2, 3), AP



	Total	Number of Days Outstanding				
		0-30	31-60	61-90	91-120	Over 120
Accounts receivable	\$377,000	\$222,000	\$90,000	\$38,000	\$15,000	\$12,000
% uncollectible	1%	4%	5%	8%	10%	
	Total	Number of Days Outstanding				
		0-30	31-60	61-90	91-120	Over 120
Estimated bad debts						

- (a) Calculate the total estimated bad debts based on the above information.

(a) Tot est.

bad debts \$10,120

- (b) Prepare the year-end adjusting journal entry to record the bad debts using the aged uncollectible accounts receivable determined in (a). Assume the unadjusted balance in Allowance for Doubtful Accounts is a \$4,000 debit.
- (c) Of the above accounts, \$5,000 is determined to be specifically uncollectible. Prepare the journal entry to write off the uncollectible account.
- (d) The company collects \$5,000 subsequently on a specific account that had previously been determined to be uncollectible in (c). Prepare the journal entry(ies) necessary to restore the account and record the cash collection.
- (e) Comment on how your answers to (a)–(d) would change if Reynolds.com used 3% of total accounts receivable, rather than aging the accounts receivable. What are the advantages to the company of aging the accounts receivable rather than applying a percentage to total accounts receivable?

P8-2A At December 31, 2013, Weiss Imports reported this information on its balance sheet.

Prepare journal entries related to bad debt expense, and compute ratios.

(LO 2, 3, 8), AP



Accounts receivable	\$600,000
Less: Allowance for doubtful accounts	37,000

During 2014, the company had the following transactions related to receivables.

1. Sales on account	\$2,500,000
2. Sales returns and allowances	50,000
3. Collections of accounts receivable	2,200,000
4. Write-offs of accounts receivable deemed uncollectible	41,000
5. Recovery of bad debts previously written off as uncollectible	15,000

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- (a) Prepare the journal entries to record each of these five transactions. Assume that no cash discounts were taken on the collections of accounts receivable. (Omit cost of goods sold entries.)
- (b) Enter the January 1, 2014, balances in Accounts Receivable and Allowance for Doubtful Accounts, post the entries to the two accounts (use T-accounts), and determine the balances.

(b) A/R bal. \$809,000

- (c) Prepare the journal entry to record bad debt expense for 2014, assuming that aging the accounts receivable indicates that estimated bad debts are \$46,000.
- (d) Compute the accounts receivable turnover and average collection period.

P8-3A Presented below is an aging schedule for Bosworth Company.

Journalize transactions related to bad debts.

(LO 2, 3), AP



Customer	Total	Not Yet Due	Number of Days Past Due			
			1–30	31–60	61–90	Over 90
Aneesh	\$ 24,000		\$ 9,000	\$15,000		
Bird	30,000	\$ 30,000				
Cope	50,000	5,000	5,000		\$40,000	
DeSpears	38,000					\$38,000
Others	120,000	72,000	35,000	13,000		
	\$262,000	\$107,000	\$49,000	\$28,000	\$40,000	\$38,000
Estimated percentage uncollectible		3%	7%	12%	24%	60%
Total estimated bad debts	\$ 42,400	\$ 3,210	\$ 3,430	\$ 3,360	\$ 9,600	\$22,800

Customer	Total	Not Yet Due	Number of Days Past Due			
			1–30	31–60	61–90	Over 90

At December 31, 2013, the unadjusted balance in Allowance for Doubtful Accounts is a credit of \$8,000.

Instructions

- (a) Journalize and post the adjusting entry for bad debts at December 31, 2013. (Use T-accounts.)
- (b) Journalize and post to the allowance account these 2014 events and transactions:
 - 1. March 1, a \$600 customer balance originating in 2013 is judged uncollectible.
 - 2. May 1, a check for \$600 is received from the customer whose account was written off as uncollectible on March 1.
- (c) Journalize the adjusting entry for bad debts at December 31, 2014, assuming that the unadjusted balance in Allowance for Doubtful Accounts is a debit of \$1,400 and the aging schedule indicates that total estimated bad debts will be \$36,700.

P8-4A Here is information related to Freeman Company for 2014.

Compute bad debt amounts.

(LO 3), AP

Total credit sales	\$1,500,000
Accounts receivable at December 31	840,000
Bad debts written off	37,000

Instructions

- (a) What amount of bad debt expense will Freeman Company report if it uses the direct write-off method of accounting for bad debts?
- (b) Assume that Freeman Company decides to estimate its bad debt expense based on 4% of accounts receivable. What amount of bad debt expense will the company record if Allowance for Doubtful Accounts has a credit balance of \$3,000?
- (c) Assume the same facts as in part (b), except that there is a \$1,000 debit balance in Allowance for Doubtful Accounts. What amount of bad debt expense will Freeman record?
- (d)  What is a weakness of the direct write-off method of reporting bad debt expense?

P8-5A At December 31, 2014, the trial balance of Sloane Company contained the following amounts before adjustment.

Journalize entries to record transactions related to bad debts.

	Debit	Credit
	_____	_____
Accounts Receivable	\$180,000	
Allowance for Doubtful Accounts		\$ 1,500
Sales Revenue		875,000

Instructions

- (a) Prepare the adjusting entry at December 31, 2014, to record bad debt expense, assuming that the aging schedule indicates that \$10,200 of accounts receivable will be uncollectible.
- (b) Repeat part (a), assuming that instead of a credit balance there is a \$1,500 debit balance in Allowance for Doubtful Accounts.
- (c) During the next month, January 2015, a \$2,100 account receivable is written off as uncollectible. Prepare the journal entry to record the write-off.
- (d) Repeat part (c), assuming that Sloane Company uses the direct write-off method instead of the allowance method in accounting for uncollectible accounts receivable.
- (e)  What are the advantages of using the allowance method in accounting for uncollectible accounts as compared to the direct write-off method?

P8-6A On January 1, 2014, Oswalt Company had Accounts Receivable of \$54,200 and Allowance for Doubtful Accounts of \$3,700. Oswalt Company prepares financial statements annually. During the year, the following selected transactions occurred.

Journalize various receivables transactions.

(LO 2, 4, 5), AP

Jan. 5 Sold \$4,000 of merchandise to Ross Company, terms n/30.

Feb. 2 Accepted a \$4,000, 4-month, 9% promissory note from Ross Company for balance due.

12 Sold \$12,000 of merchandise to Cano Company and accepted Cano's \$12,000, 2-month, 10% note for the balance due.

26 Sold \$5,200 of merchandise to Meachum Co., terms n/10.

Apr. 5 Accepted a \$5,200, 3-month, 8% note from Meachum Co. for balance due.

12 Collected Cano Company note in full.

15 Sold \$2,000 of merchandise to Glanville Inc. and accepted a \$2,000, 6-month, 12% note for the amount due.

Instructions

Journalize the transactions. (Omit cost of goods sold entries.)

P8-7A The president of Giraldi Enterprises asks if you could indicate the impact certain transactions have on the following ratios.

Explain the impact of transactions on ratios.

(LO 8), C



<u>Transaction</u>	<u>Current Ratio (2:1)</u>	<u>Accounts Receivable Turnover (10×)</u>	<u>Average Collection Period (36.5 days)</u>
1. Received \$5,000 on cash sale. The cost of the goods sold was \$2,600.			
2. Recorded bad debt expense of \$500 using allowance method.			
3. Wrote off a \$100 account receivable as uncollectible (Uses allowance method.)			
4. Recorded \$2,500 sales on account. The cost of the goods sold was \$1,500.			

Instructions

Complete the table, indicating whether each transaction will increase (I), decrease (D), or have no effect (NE) on the specific ratios provided for Giraldi Enterprises.

P8-8A Kolton Company closes its books on its July 31 year-end. The company does not make entries to accrue for interest except at its year-end. On June 30, the Notes Receivable account balance is \$23,800. Notes Receivable include the following.

Prepare entries for various credit card and notes receivable transactions.

(LO 4, 5, 6, 9), AP



Date	Maker	Face Value	Term	Maturity Date	Interest Rate
April 21	Booth Inc.	\$ 6,000	90 days	July 20	8%
May 25	Manning Co.	7,800	60 days	July 24	10%
June 30	ANF Corp.	10,000	6 months	December 31	6%

During July, the following transactions were completed.

July 5 Made sales of \$4,500 on Kolton credit cards.

14 Made sales of \$600 on Visa credit cards. The credit card service charge is 3%.

20 Received payment in full from Booth Inc. on the amount due.

24 Received payment in full from Manning Co. on the amount due.

Instructions

- (a) Journalize the July transactions and the July 31 adjusting entry for accrued interest receivable. (Interest is computed using 360 days; omit cost of goods sold entries.)
- (b) Enter the balances at July 1 in the receivable accounts and post the entries to all of the receivable accounts. (Use T-accounts.)

(b) A/R bal. \$ 4,500

- (c) Show the balance sheet presentation of the receivable accounts at July 31.

(c) Tot. receivables \$14,550

P8-9A Suppose the amounts presented here are basic financial information (in millions) from the 2014 annual reports of Nike and adidas.

Calculate and interpret various ratios.

(LO 7, 8), AN



Nike adidas

Sales revenue	\$19,176.1	\$10,381
Allowance for doubtful accounts, beginning	78.4	119
Allowance for doubtful accounts, ending	110.8	124
Accounts receivable balance (gross), beginning	2,873.7	1,743
Accounts receivable balance (gross), ending	2,994.7	1,553

Instructions

Calculate the accounts receivable turnover and average collection period for both companies. Comment on the difference in their collection experiences.

Problems: Set B

P8-1B The following represents selected information taken from a company’s aging schedule to estimate uncollectible accounts receivable at year-end.

Journalize transactions related to bad debts.

(LO 2, 3), AP



	Total	Number of Days Outstanding				
		0–30	31–60	61–90	91–120	Over 120
Accounts receivable	\$305,000	\$107,000	\$60,000	\$50,000	\$38,000	\$50,000
% uncollectible	2%	5%	7.5%	10%	25%	
Estimated bad debts						

Instructions

	Total	Number of Days Outstanding				
		0–30	31–60	61–90	91–120	Over 120
(a) Calculate the total estimated bad debts based on the above information.						
(a) Tot. est. bad debts	\$25,190					

- (b) Prepare the year-end adjusting journal entry to record the bad debts using the allowance method and the aged uncollectible accounts receivable determined in (a). Assume the unadjusted balance in Allowance for Doubtful Accounts is a \$7,000 credit.
- (c) Of the above accounts, \$2,600 is determined to be specifically uncollectible. Prepare the journal entry to write off the uncollectible accounts.
- (d) The company subsequently collects \$1,200 on a specific account that had previously been determined to be uncollectible in (c). Prepare the journal entry(ies) necessary to restore the account and record the cash collection.
- (e) Explain how establishing an allowance account satisfies the expense recognition principle.

P8-2B At December 31, 2013, Dustin Company reported this information on its balance sheet.

Prepare journal entries related to bad debt expense, and compute ratios.

(LO 2, 3, 8), AP



Accounts receivable	\$960,000
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Less: Allowance for doubtful accounts	78,000
---------------------------------------	--------

During 2014, the company had the following transactions related to receivables.

1. Sales on account	\$3,600,000
2. Sales returns and allowances	150,000
3. Collections of accounts receivable	3,100,000
4. Write-offs of accounts receivable deemed uncollectible	92,000
5. Recovery of bad debts previously written off as uncollectible	28,000

Instructions

- (a) Prepare the journal entries to record each of these five transactions. Assume that no cash discounts were taken on the collections of accounts receivable. (Omit cost of goods sold entries.)
- (b) Enter the January 1, 2014, balances in Accounts Receivable and Allowance for Doubtful Accounts, post the entries to the two accounts (use T-accounts), and determine the balances.

(b) A/R bal. \$1,218,000

- (c) Prepare the journal entry to record bad debt expense for 2014, assuming that aging the accounts receivable indicates that expected bad debts are \$140,000.
- (d) Compute the accounts receivable turnover and average collection period.

(LO 2, 3), AP



Customer	Total	Not Yet Due	Number of Days Past Due			
			1–30	31–60	61–90	Over 90
Allen	\$ 18,000		\$12,000	\$ 6,000		
Brian	24,000				\$24,000	
Charles	40,000	\$ 25,000	15,000			
Dwight	52,000					\$52,000
Others	196,000	97,000	60,000	39,000		
	\$330,000	\$122,000	\$87,000	\$45,000	\$24,000	\$52,000
Estimated percentage uncollectible		1%	3%	9%	20%	40%
Total estimated uncollectible accounts	\$ 33,480	\$ 1,220	\$ 2,610	\$ 4,050	\$ 4,800	\$20,800

At December 31, 2013, the unadjusted balance in Allowance for Doubtful Accounts is a credit of \$9,000.

Instructions

- (a) Journalize and post the adjusting entry for bad debts at December 31, 2013. (Use T-accounts.)
- (b) Journalize and post to the allowance account these 2014 events and transactions:
 - 1. February 1, a \$900 customer balance originating in 2013 is judged uncollectible.

- (c) Journalize the adjusting entry for bad debts at December 31, 2014, assuming that the unadjusted balance in Allowance for Doubtful Accounts is a debit of \$2,800 and the aging schedule indicates that total estimated uncollectible accounts will be \$30,600.

P8-4B Here is information related to Orson Company for 2014.

Compute bad debt amounts.

(LO 3), AP

Total credit sales	\$1,800,000
Accounts receivable at December 31	500,000
Bad debts written off	15,000

Instructions

- (a) What amount of bad debt expense will Orson Company report if it uses the direct write-off method of accounting for bad debts?
- (b) Assume that Orson Company decides to estimate its bad debt expense based on 4% of accounts receivable. What amount of bad debt expense will the company record if it has an Allowance for Doubtful Accounts credit balance of \$3,700?
- (c) Assume the same facts as in part (b), except that there is a \$2,000 debit balance in Allowance for Doubtful Accounts. What amount of bad debt expense will Orson record?
- (d)  What is the weakness of the direct write-off method of reporting bad debt expense?

P8-5B At December 31, 2014, the trial balance of Valcik Company contained the following amounts before adjustment.

Journalize entries to record transactions related to bad debts.

(LO 2, 3), AP

	Debit	Credit
Accounts Receivable	\$120,000	
Allowance for Doubtful Accounts		\$ 2,800
Sales Revenue		680,000

Instructions

- (a) Prepare the adjusting entry at December 31, 2014, to record bad debt expense, assuming that the aging schedule indicates that \$7,600 of accounts receivable will be uncollectible.
- (b) Repeat part (a) assuming that instead of a credit balance there is a \$2,500 debit balance in Allowance for Doubtful Accounts.
- (c) During the next month, January 2015, a \$750 account receivable is written off as uncollectible. Prepare the journal entry to record the write-off.
- (d) Repeat part (c), assuming that Valcik Company uses the direct write-off method instead of the allowance method in accounting for uncollectible accounts receivable.
- (e)  What are the advantages of using an aging schedule and the allowance method in accounting for uncollectible accounts as compared to the direct write-off method?

P8-6B On January 1, 2014, Alter Company had Accounts Receivable \$154,000; Notes Receivable of \$12,000; and Allowance for Doubtful Accounts of \$13,200. The note receivable is from Hartwig Company. It is a 4-month, 9% note dated December 31, 2013. Alter Company prepares financial statements annually. During the year, the following selected transactions occurred.

Journalize various receivables transactions.

(LO 2, 4, 5), AP

- Jan. 5 Sold \$10,000 of merchandise to Flynn Company, terms n/15.
- 20 Accepted Flynn Company's \$10,000, 3-month, 6% note for balance due.
- Feb. 18 Sold \$4,000 of merchandise to Mink Company and accepted Mink's \$4,000, 6-month, 8% note for the amount due.
- Apr. 20 Collected Flynn Company note in full.
- 30 Received payment in full from Hartwig Company on the amount due.
- May 25 Accepted Creech Inc.'s \$9,000, 6-month, 4% note in settlement of a past-due balance on account.
- Aug. 18 Received payment in full from Mink Company on note due.
- Sept. 1 Sold \$5,000 of merchandise to Glazer Company and accepted a \$5,000, 6-month, 6% note for the amount due.

Instructions

Journalize the transactions. (Omit cost of goods sold entries.)

P8-7B The president of Thompson Enterprises asks if you could indicate the impact certain transactions have on the following ratios.

Explain the impact of transactions on ratios.

(LO 8), C

<u>Transaction</u>	<u>Current Ratio (2:1)</u>	<u>Accounts Receivable Turnover (10×)</u>	<u>Average Collection Period (36.5 days)</u>
1. Recorded \$4,300 sales on account. The cost of the goods sold was \$2,000.			
2. Recorded bad debt expense of \$700 using allowance method.			
3. Wrote off a \$300 account receivable as uncollectible (uses allowance method).			
4. Collected a \$200 account receivable that had previously been written off.			

Instructions

Complete the table, indicating whether each transaction will increase (I), decrease (D), or have no effect (NE) on the specific ratios provided for Thompson Enterprises.

P8-8B Durhan Company closes its books on its October 31 year-end. The company does not make entries to accrue for interest except at its year-end. On September 30, the Notes Receivable account balance is \$22,800. Notes Receivable include the following.

Prepare entries for various credit card and notes receivable transactions.

(LO 4, 5, 6, 9), AP



<u>Date</u>	<u>Maker</u>	<u>Face Value</u>	<u>Term</u>	<u>Maturity Date</u>	<u>Interest Rate</u>
Aug. 16	Stuhmer Inc.	\$10,000	60 days	Oct. 15	6%
Aug. 25	Moberg Co.	3,000	2 months	Oct. 25	7%
Sept. 30	Earnest Corp.	9,800	6 months	Mar. 30	6%

Oct. 7 Made sales of \$4,600 on Durhan credit cards.

12 Made sales of \$600 on Visa credit cards. The credit card service charge is 3%.

15 Received payment in full from Stuhmer Inc. on the amount due.

25 Received payment in full from Moberg Co. on amount due.

Instructions

- (a) Journalize the October transactions and the October 31 adjusting entry for accrued interest receivable. (Interest is computed using 360 days; omit cost of goods sold entries.)
- (b) Enter the balances at October 1 in the receivable accounts and post the entries to all of the receivable accounts. (Use T-accounts.)

(b) A/R bal. \$4,600

- (c) Show the balance sheet presentation of the receivable accounts at October 31, 2014.

(c) Tot. receivables \$14,449

P8-9B Suppose the following financial information (in millions) is from the 2014 annual reports of **Redbird Sportswear** and **The Carwright Company**.

Calculate and interpret various ratios.

(LO 7, 8), AN



	Redbird	Carwright
Sales revenue	\$1,200.0	\$1,350.0
Allowance for doubtful accounts, Jan. 1	6.7	12.5
Allowance for doubtful accounts, Dec. 31	7.4	14.8
Accounts receivable balance (gross), Jan. 1	293.3	216.5

	Redbird	Carwright
Accounts receivable balance (gross), Dec. 31	307.2	202.9

Instructions

Calculate the accounts receivable turnover and average collection period for both companies. Comment on the difference in their collection experiences.

Problems: Set C

Visit the book’s companion website, at www.wiley.com/college/kimmel, and choose the Student Companion site to access Problem Set C.

Comprehensive Problem

CP8 Madson Corporation’s balance sheet at December 31, 2013, is presented below.

MADSON CORPORATION
Balance Sheet
December 31, 2013

Cash	\$13,100	Accounts payable	\$ 8,750
Accounts receivable	19,780	Common stock	20,000
Allowance for doubtful accounts	(800)	Retained earnings	12,730
Inventory	<u>9,400</u>		
	\$41,480		\$41,480

- During January 2014, the following transactions occurred. Madson uses the perpetual inventory method.
- Jan. 1 Madson accepted a 4-month, 8% note from Matheny Company in payment of Matheny’s \$1,200 account.
- 3 Madson wrote off as uncollectible the accounts of Payton Corporation (\$450) and Cruz Company (\$280).

11 Madson sold for \$25,000 on account inventory that cost \$17,500.

15 Madson sold inventory that cost \$700 to Rich Jensen for \$1,000. Jensen charged this amount on his Visa First Bank card. The service fee charged Madson by First Bank is 3%.

17 Madson collected \$22,900 from customers on account.

21 Madson paid \$16,300 on accounts payable.

24 Madson received payment in full (\$280) from Cruz Company on the account written off on January 3.

27 Madson purchased advertising supplies for \$1,400 cash.

31 Madson paid other operating expenses, \$3,218.

Adjustment data:

- 1. Interest is recorded for the month on the note from January 1.
- 2. Bad debts are expected to be 6% of the January 31, 2014, accounts receivable.
- 3. A count of advertising supplies on January 31, 2014, reveals that \$560 remains unused.
- 4. The income tax rate is 30%. (*Hint:* Prepare the income statement up to “Income before taxes” and multiply by 30% to compute the amount; round to whole dollars.)

Instructions

(You may want to set up T-accounts to determine ending balances.)

- (a) Prepare journal entries for the transactions listed above and adjusting entries. (Include entries for cost of goods sold using the perpetual inventory system.)
- (b) Prepare an adjusted trial balance at January 31, 2014.
- (c) Prepare an income statement and a retained earnings statement for the month ending January 31, 2014, and a classified balance sheet as of January 31, 2014.

Continuing Cookie Chronicle

(*Note:* This is a continuation of the Cookie Chronicle from [Chapters 1](#) through [7](#).)



CCC8 One of Natalie's friends, Curtis Lesperance, runs a coffee shop where he sells specialty coffees and prepares and sells muffins and cookies. He is eager to buy one of Natalie's fine European mixers, which would enable him to make larger batches of muffins and cookies. However, Curtis cannot afford to pay for the mixer for at least 30 days. He asks Natalie if she would be willing to sell him the mixer on credit. Natalie comes to you for advice.

Go to the book's companion website, at www.wiley.com/college/kimmel, to see the completion of this problem.

Broadening Your Perspective

Financial Reporting and Analysis

FINANCIAL REPORTING PROBLEM: *Tootsie Roll Industries, Inc.*

BYP8-1 Refer to the financial statements of *Tootsie Roll Industries* and the accompanying notes to its financial statements in [Appendix A](#).



Instructions

- (a) Calculate the accounts receivable turnover and average collection period for 2011. (Use "Net Product Sales." Assume all sales were credit sales.)
- (b) Did Tootsie Roll have any potentially significant credit risks in 2011?

COMPARATIVE ANALYSIS PROBLEM: *Tootsie Roll vs. Hershey*

BYP8-2 The financial statements of **The Hershey Company** are presented in [Appendix B](#), following the financial statements for **Tootsie Roll** in [Appendix A](#).



Instructions

- (a) Based on the information contained in these financial statements, compute the following 2011 values for each company.
 - (1) Accounts receivable turnover. (For Tootsie Roll, use “Net product sales.” Assume all sales were credit sales.)
 - (2) Average collection period for accounts receivable.
- (b) What conclusions concerning the management of accounts receivable can be drawn from these data?

RESEARCH CASE

BYP8-3 The August 31, 2009, issue of the *Wall Street Journal* includes an article by Serena Ng and Cari Tuna entitled “Big Firms Are Quick to Collect, Slow to Pay.”

Instructions

Read the article and answer the following questions.

- (a) How many days did **InBev** tell its suppliers that it was going to take to pay? How many days did it take previously?
- (b) What steps did **General Electric** take to free up cash? How much cash did it free up?
- (c) On average, how many days did companies with more than \$5 billion take to pay suppliers, and how many days did they take to collect from their customers? How did this compare to companies with less than \$500 million in sales?
- (d) Are there any risks involved with being too tough in negotiating delayed payment terms with suppliers?

INTERPRETING FINANCIAL STATEMENTS

BYP8-4 Suppose the information below is from the 2014 financial statements and accompanying notes of **The Scotts Company**, a major manufacturer of lawn-care products.

(in millions)	2014	2013
Accounts receivable	\$ 270.4	\$ 259.7
Allowance for uncollectible accounts	10.6	11.4
Sales revenue	2,981.8	2,871.8

(in millions)	2014	2013
Total current assets	1,044.9	999.3

THE SCOTTS COMPANY: Notes to the Financial Statements

Note 19. Concentrations of Credit Risk

Financial instruments which potentially subject the Company to concentration of credit risk consist principally of trade accounts receivable. The Company sells its consumer products to a wide variety of retailers, including mass merchandisers, home centers, independent hardware stores, nurseries, garden outlets, warehouse clubs, food and drug stores and local and regional chains. Professional products are sold to commercial nurseries, greenhouses, landscape services and growers of specialty agriculture crops. Concentrations of accounts receivable at September 30, net of accounts receivable pledged under the terms of the New MARP Agreement whereby the purchaser has assumed the risk associated with the debtor's financial inability to pay (\$146.6 million and \$149.5 million for 2014 and 2013, respectively), were as follows.

	2014	2013
Due from customers geographically located in North America	53%	52%
Applicable to the consumer business	61%	54%
Applicable to Scotts LawnService [®] , the professional businesses (primarily distributors), Smith & Hawken [®] and Morning Song [®]	39%	46%
Top 3 customers within consumer business as a percent of total consumer accounts receivable	0%	0%

The remainder of the Company's accounts receivable at September 30, 2014 and 2013, were generated from customers located outside of North America, primary retailers, distributors, nurseries and growers in Europe. No concentrations of customers of individual customers within this group account for more than 10% of the Company's accounts receivable at either balance sheet date.

The Company's three largest customers are reported within the Global Consumer segment, and are the only customers that individually represent more than 10% of reported consolidated net sales for each of the last three fiscal years. These three customers accounted for the following percentages of consolidated net sales for the fiscal years ended September 30:

Largest Customer	2nd Largest Customer	3rd Largest Customer
-------------------------	-----------------------------	-----------------------------

2014	21.0%	13.5%	13.4%
2013	20.2%	10.9%	10.2%
2012	21.5%	11.2%	10.5%

Instructions

Answer each of the following questions.

- (a) Calculate the accounts receivable turnover and average collection period for 2014 for the company.
- (b) Is accounts receivable a material component of the company’s total 2014 current assets?
- (c) Scotts sells seasonal products. How might this affect the accuracy of your answer to part (a)?
- (d) Evaluate the credit risk of Scotts’ 2014 concentrated receivables.
- (e) Comment on the informational value of Scotts’ Note 19 on concentrations of credit risk.

REAL-WORLD FOCUS

BYP8-5 Purpose: To learn more about factoring from websites that provide factoring services.

Address: www.ccapital.net, or go to www.wiley.com/college/kimmel

Instructions

Go to the website, click on **Invoice Factoring**, and answer the following questions.

- (a) What are some of the benefits of factoring?
- (b) What is the range of the percentages of the typical discount rate?
- (c) If a company factors its receivables, what percentage of the value of the receivables can it expect to receive from the factor in the form of cash, and how quickly will it receive the cash?

Critical Thinking

DECISION-MAKING ACROSS THE ORGANIZATION

BYP8-6 Jan and Roy Falcon own Club Fab. From its inception, Club Fab has sold merchandise on either a cash or credit basis, but no credit cards have been accepted. During the past several months, the Falcons have begun to question their credit-sales policies. First, they have lost some sales because of their refusal to accept credit cards. Second, representatives of two metropolitan banks have convinced them to accept their national credit cards. One bank, City National Bank, has stated that (1) its credit card fee is 4% and (2) it pays the retailer 96 cents on each \$1 of sales within 3 days of receiving the credit card billings.

The Falcons decide that they should determine the cost of carrying their own credit sales. From the accounting records of the past 3 years, they accumulate these data:

2014	2013	2012
_____	_____	_____

Net credit sales	\$500,000	\$600,000	\$400,000
Collection agency fees for slow-paying customers	2,900	2,600	1,600
Salary of part-time accounts receivable clerk	4,400	4,400	4,400

Credit and collection expenses as a percentage of net credit sales are as follows: uncollectible accounts 1.6%, billing and mailing costs .5%, and credit investigation fee on new customers .2%.

Jan and Roy also determine that the average accounts receivable balance outstanding during the year is 5% of net credit sales. The Falcons estimate that they could earn an average of 10% annually on cash invested in other business opportunities.

Instructions

With the class divided into groups, answer the following.

- (a) Prepare a tabulation for each year showing total credit and collection expenses in dollars and as a percentage of net credit sales.
- (b) Determine the net credit and collection expenses in dollars and as a percentage of sales after considering the revenue not earned from other investment opportunities. (*Note:* The income lost on the cash held by the bank for 3 days is considered to be immaterial.)
- (c) Discuss both the financial and nonfinancial factors that are relevant to the decision.

COMMUNICATION ACTIVITY

BYP8-7 Santana Corporation is a recently formed business selling the “World’s Best Doormat.” The corporation is selling doormats faster than Santana can make them. It has been selling the product on a credit basis, telling customers to “pay when they can.” Oddly, even though sales are tremendous, the company is having trouble paying its bills.

Instructions

Write a memo to the president of Santana Corporation discussing these questions:

- (a) What steps should be taken to improve the company’s ability to pay its bills?
- (b) What accounting steps should be taken to measure its success in improving collections and in recording its collection success?
- (c) If the corporation is still unable to pay its bills, what additional steps can be taken with its receivables to ease its liquidity problems?

ETHICS CASE

BYP8-8 As its year-end approaches, it appears that Ortiz Corporation’s net income will increase 10% this year. The president of Ortiz Corporation, nervous that the stockholders might expect the company to sustain this 10% growth rate in net income in future years, suggests that the controller increase the allowance for doubtful accounts to 4% of receivables in order to lower this year’s net income. The president thinks that the lower net income, which reflects a 6% growth rate, will be a more sustainable rate of growth for Ortiz Corporation in future years. The controller of Ortiz Corporation believes that the company’s yearly allowance for doubtful accounts should be 2% of receivables.

Instructions

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- (a) Who are the stakeholders in this case?
- (b) Does the president's request pose an ethical dilemma for the controller?
- (c) Should the controller be concerned with Ortiz Corporation's growth rate in estimating the allowance?

Explain your answer.

ALL ABOUT YOU

BYP8-9 Credit card usage in the United States is substantial. Many startup companies use credit cards as a way to help meet short-term financial needs. The most common forms of debt for startups are use of credit cards and loans from relatives.

Suppose that you start up Spangles Sandwich Shop. You invested your savings of \$20,000 and borrowed \$70,000 from your relatives. Although sales in the first few months are good, you see that you may not have sufficient cash to pay expenses and maintain your inventory at acceptable levels, at least in the short term. You decide you may need to use one or more credit cards to fund the possible cash shortfall.

Instructions

- (a) Go to the Internet and find two sources that provide insight into how to compare credit card terms.
- (b) Develop a list, in descending order of importance, as to what features are most important to you in selecting a credit card for your business.
- (c) Examine the features of your present credit card. (If you do not have a credit card, select a likely one online for this exercise.) Given your analysis above, what are the three major disadvantages of your present credit card?

FASB CODIFICATION ACTIVITY

BYP8-10 If your school has a subscription to the FASB Codification, go to <http://aaahq.org/ascLogin.cfm> to log in and prepare responses to the following.

- (a) How are receivables defined in the Codification?
- (b) What are the conditions under which losses from uncollectible receivables (Bad Debt Expense) should be reported?

Answers to Insight and Accounting Across the Organization Questions

p. 406 When Investors Ignore Warning Signs Q: When would it be appropriate for a company to lower its allowance for doubtful accounts as a percentage of its receivables? **A:** It would be appropriate for a company to lower its allowance for doubtful accounts as a percentage of its receivables if the company's collection experience had improved, or was expected to improve, and therefore the company expected lower defaults as a percentage of receivables.

p. 409 Can Fair Value Be Unfair? Q: What are the arguments in favor of and against fair value accounting for loans and receivables? **A:** Arguments in favor of fair value accounting for loans and receivables are that fair value would provide a more accurate view of a company's financial position. This might provide a useful early warning of when a bank or other financial institution was in trouble because its loans were of poor quality. But, banks argue that estimating fair values is very difficult to do accurately. They are also concerned that volatile fair values could cause large swings in a bank's reported net income.

p. 413 Bad Information Can Lead to Bad Loans Q: What steps should the banks have taken to ensure the accuracy of financial information provided on loan applications? **A:** At a minimum, the bank should have requested copies of recent income tax forms and contacted the supposed employer to verify income. To verify ownership and value of assets, it should have examined bank statements, investment statements, and title documents, and should have employed appraisers.

P. 418 - Pay for Receivables? What issues should management consider in deciding whether to factor its receivables? **A:** Management must prepare a cash budget and evaluate its projected cash needs. If it projects a cash deficiency, it should first pursue traditional bank financing since it tends to be less expensive than factoring. If traditional financing is not available, management could pursue factoring. If carefully structured, a factoring arrangement can be cost-effective since it can enable the company to outsource many billing and collection activities.

Answers to Self-Test Questions

1. c 2. c $(\$1,000 - \$300) \times (100\% - 2\%)$ 3. a 4. a $(\$160,000 \times .075)$ 5. c $(\$200,000 \times .10) + (\$30,000 - \$18,000)$ 6. d $(\$800,000 - \$65,000)$ 7. c 8. b 9. d 10. d 11. a $\$800,000 \div ((\$100,000 + \$150,000) \div 2)$ 12. c $(365 \text{ days} \div 7)$ 13. c 14. a 15. d



A Look at IFRS

The basic accounting and reporting issues related to recognition and measurement of receivables, such as the use of allowance accounts, how to record discounts, use of the allowance method to account for bad debts, and factoring, are essentially the same between IFRS and GAAP.

LEARNING OBJECTIVE 10

Compare the accounting procedures for receivables under GAAP and IFRS.

KEY POINTS

- IFRS requires that loans and receivables be accounted for at amortized cost, adjusted for allowances for doubtful accounts. IFRS sometimes refers to these allowances as **provisions**. The entry to record the allowance would be:

Bad Debt Expense

XXXXXX

Allowance for Doubtful Accounts

XXXXXX

- Although IFRS implies that receivables with different characteristics should be reported separately, there is no standard that mandates this segregation.
- The FASB and IASB have worked to implement fair value measurement (the amount they currently could be sold for) for financial instruments. Both Boards have faced bitter opposition from various factions. As a consequence, the Boards have adopted a piecemeal approach. The first step is disclosure of fair value information in the notes. The second step is the **fair value option**, which permits, but does not require, companies to record some types of financial instruments at fair values in the financial statements.
- IFRS requires a two-tiered approach to test whether the value of loans and receivables are impaired. First, a company should look at specific loans and receivables to determine whether they are impaired. Then, the loans and receivables as a group should be evaluated for impairment. GAAP does not prescribe a similar two-tiered approach.
- IFRS and GAAP differ in the criteria used to determine how to record a factoring transaction. IFRS is a combination of an approach focused on risks and rewards and loss of control. GAAP uses loss of control as the primary criterion. In addition, IFRS permits partial derecognition of receivables; GAAP does not.

LOOKING TO THE FUTURE

It appears likely that the question of recording fair values for financial instruments will continue to be an important issue to resolve as the Boards work toward convergence. Both the IASB and the FASB have indicated that they believe that financial statements would be more transparent and understandable if companies recorded and reported all financial instruments at fair value. That said, in *IFRS 9*, which was issued in 2009, the IASB created a split model, where some financial instruments are recorded at fair value, but other financial assets, such as loans and receivables, can be accounted for at amortized cost if certain criteria are met. Critics say that this can result in two companies with identical securities accounting for those securities in different ways. A proposal by the FASB would require that nearly all financial instruments, including loans and receivables, be accounted for at fair value. It has been suggested that *IFRS 9* will likely be changed or replaced as the FASB and IASB continue to deliberate the best treatment for financial instruments. In fact, one past member of the IASB said that companies should ignore *IFRS 9* and continue to report under the old standard because in his opinion, it was extremely likely that it would be changed before 2013, the mandatory adoption date of the standard. An ongoing FASB/IASB project on financial instruments addresses a number of issues with implications for receivables.

IFRS PRACTICE

IFRS SELF-TEST QUESTIONS

1.

Under IFRS, loans and receivables are to be reported on the statement of financial position at:

- (a) amortized cost.
- (b) amortized cost adjusted for estimated loss provisions.
- (c) historical cost.
- (d) replacement cost.

2.

Which of the following statements is **false**?

- (a) Loans and receivables include equity securities purchased by the company.
- (b) Loans and receivables include credit card receivables.
- (c) Loans and receivables include amounts owed by employees as a result of company loans to employees.
- (d) Loans and receivables include amounts resulting from transactions with customers.

3.

In recording a factoring transaction:

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- (a) IFRS focuses on loss of control.
- (b) GAAP focuses on loss of control and risks and rewards.
- (c) IFRS and GAAP allow partial derecognition.
- (d) IFRS allows partial derecognition

4.

Under IFRS:

- (a) the entry to record estimated uncollected accounts is the same as GAAP.
- (b) loans and receivables should only be tested for impairment as a group.
- (c) it is always acceptable to use the direct write-off method.
- (d) all financial instruments are recorded at fair value.

5.

Which of the following statements is **true**?

- (a) The fair value option requires that some types of financial instruments be recorded at fair value.
- (b) The fair value option permits, but does not require, that some types of financial instruments be recorded at fair value.
- (c) The fair value option requires that all types of financial instruments be recorded at fair value.
- (d) The FASB and IASB would like to reduce the reliance on fair value accounting for financial instruments in the future.

IFRS CONCEPTS AND APPLICATION

IFRS8-1 What are some steps taken by both the FASB and IASB to move to fair value measurement for financial instruments? In what ways have some of the approaches differed?

INTERNATIONAL FINANCIAL REPORTING PROBLEM: *Zetar plc*

IFRS8-2 The financial statements of **Zetar plc** are presented in [Appendix C](#). The company's complete annual report, including the notes to its financial statements, is available in the Investors section at www.zetarplc.com.

Instructions

Use the company's annual report to answer the following questions.

- (a) According to the Operational Review of Financial Performance, what was one reason why the balance in receivables increased relative to the previous year?
- (b) According to the notes to the financial statements, how are loans and receivables defined?
- (c) Using the notes to the financial statements, what amount of trade receivables were written off (utilised) during 2011?
- (d) Using information in the notes to the financial statements, determine what percentage the provision for impairment of receivables was as a percentage of total trade receivables for 2011 and 2010. How did the ratio change from 2010 to 2011, and what does this suggest about the company's receivables?

Answers to IFRS Self-Test Questions

1. b 2. a 3. d 4. a 5. b



- Remember to go back to The Navigator box on the chapter opening page and check off your completed work.

1

If seasonal factors are significant, determine the average accounts receivable balance by using monthly or quarterly amounts.

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