

# CHAPTER REVIEW

## Types of Receivables

1. (S.O. 1) **Receivables** are claims that are expected to be collected in cash. The three major classes of receivables are usually classified as: (a) accounts, (b) notes, and (c) other.
2. **Accounts receivable** are amounts owed by customers on account. **Notes receivable** represent claims for which formal instruments of credit are issued as evidence of debt. And **other receivables** include nontrade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable.

## Recognizing Accounts Receivable

3. (S.O. 2) When a business sells merchandise to a customer on credit, Accounts Receivable is debited and Sales is credited.
4. If a payment is received by a customer within the discount period, the following entry is made:

Cash.....	XXX	
Sales Discounts.....	XXX	
Accounts Receivable .....		XXX

## Valuing Accounts Receivable

5. (S.O. 3) In accounting, credit losses are debited to Bad Debts Expense or Uncollectible Accounts Expense. Such losses are considered to be a normal and necessary risk of doing business. Two methods are used in accounting for uncollectible accounts: (a) the direct write-off method and (b) the allowance method.

## Direct Write-off Method

6. Under the direct write-off method, bad debt losses are not anticipated and no allowance account is used.
  - a. No entries are made for bad debts until an account is determined to be uncollectible at which time the loss is charged to Bad Debts Expense.
  - b. This method makes no attempt to match bad debts expense to sales revenue in the income statement or to show the cash realizable value of the accounts receivable in the balance sheet.
  - c. This method is not acceptable for financial reporting purposes, unless bad debt losses are insignificant.
7. The **allowance method** is required when bad debts are material in amount. Its essential features are:
  - a. Uncollectible accounts are estimated and the expense for the uncollectible accounts is matched against sales in the same accounting period in which the sales occurred.
  - b. **Estimated uncollectibles** are debited to Bad Debts Expense and credited to Allowance for Doubtful Accounts through an adjusting entry at the end of each period.

- c. **Actual uncollectibles** are debited to Allowance for Doubtful Accounts and credited to Accounts Receivable at the time a specific account is written off.
- 8. When there is a recovery of an account that has been written off as uncollectible, it is necessary to:
  - a. reverse the entry made when the account was written off, and
  - b. record the collection in the usual manner.
- 9. There are two bases that are used to determine the amount of expected uncollectibles. One is the percentage of sales basis, and the other is the percentage of receivables basis.

**Percentage of Sales Basis**

- 10. Under the **percentage of sales basis**,
  - a. Management establishes a percentage relationship between the amount of credit sales and expected losses from uncollectible accounts.
  - b. The expected bad debt losses are determined by applying the percentage to the sales base of the current period.
  - c. This basis better matches expenses with revenues.

**Percentage of Receivables Basis**

- 11. Under the **percentage of receivables basis**,
  - a. The balance in the allowance account is derived from an analysis of individual customer accounts. The analysis is often called **aging the accounts receivable**.
  - b. The amount of the adjusting entry is the difference between the required balance and the existing balance in the allowance account.
  - c. This basis produces the better estimate of **cash realizable value** of the accounts receivable.

**Disposing Accounts Receivable**

- 12. (S.O. 4) In order to accelerate the receipt of cash from receivables, owners frequently (1) sell to a factor such as a finance company or bank, or (2) make credit card sales.
- 13. A factor buys receivables from businesses for a fee and then collects the payments directly from the customers. The entry for a sale to a factor is:

Cash.....	XXX	
Service Charge Expense .....	XXX	
Accounts Receivable .....		XXX

- 14. Credit cards are frequently used by retailers because the retailer does not have to be concerned with the customer’s credit history and the retailer can receive cash more quickly from the credit card issuer. However, the credit card issuer usually receives a fee of from 2–6% of the invoice price from the retailer.

**Notes Receivable**

- 15. (S.O. 5) A **promissory note** is a written promise to pay a specified amount of money on demand or at a definite time. The party making the promise is called the maker; the party to whom payment is made is called the payee.

16. When the life of a note is expressed in terms of months, the due date is found by counting the months from the date of issue. When the due date is stated in terms of days, it is necessary to count the days. In counting days, the date of issue is omitted but the due date is included.
17. The basic formula for computing interest on an interest bearing note is:

$$\begin{array}{ccccccc} \text{Face Value} & & \text{Annual} & & \text{Time} & & \\ \text{of Note} & \times & \text{Interest} & \times & \text{in Terms} & = & \text{Interest} \\ & & \text{Rate} & & \text{of One} & & \\ & & & & \text{Year} & & \end{array}$$

**Recognizing Notes Receivable**

18. (S.O. 6) Entries for notes receivable are required when the note is received and at maturity. To illustrate, assume that on June 1, 2009, Raider Company receives a \$2,000, 3-month, 12% note receivable from Paul Revere in settlement of an open account. The entry is:

June 1	Notes Receivable .....	2,000	
	Accounts Receivable .....		2,000

**Valuing Notes Receivable**

19. (S.O. 7) Like accounts receivable, short-term notes receivable are reported at their cash (net) realizable value and an Allowance for Doubtful Accounts is used.

**Disposing of Notes Receivable**

20. (S.O. 8) On September 1, the maturity date, Paul Revere honors the note by paying the face amount, \$2,000 plus interest of \$60 ( $\$2,000 \times 12\% \times 3/12$ ). Assuming that interest has not been accrued, the entry is:

Sept. 1	Cash .....	2,060	
	Notes Receivable .....		2,000
	Interest Revenue .....		60

21. (S.O. 9) In the balance sheet, short-term receivables are reported within the current assets section below short term investments. Both the gross amount of receivables and the allowance for doubtful accounts should be reported. In a multiple-step income statement, Bad Debts Expense and Service Charge Expense are reported as selling expenses in the operating expenses section.

## ILLUSTRATION 9-1 PERCENTAGE-OF-SALES METHOD

### Balance of Selected Accounts at Year-End (Before Adjustment)

Accounts Receivable	Allowance for Doubtful Accounts	Sales
45,600	150	150,000

Based on past experience, it is estimated that 2% of net sales will become uncollectible.  $(\$150,000 \times .02) = \$3,000$ .

### ADJUSTING ENTRY TO RECORD BAD DEBTS EXPENSE

Bad Debts Expense .....	3,000	
Allowance for Doubtful Accounts .....		3,000

### Balance of Selected Accounts at Year-End (After Adjustment)

Accounts Receivable	Allowance for Doubtful Accounts	Sales
45,600	150 3,000 3,150	150,000

### EMPHASIS ON INCOME STATEMENT RELATIONSHIPS



## ILLUSTRATION 9-2 PERCENTAGE-OF-RECEIVABLES METHOD

### Balance of Selected Accounts at Year-End (Before Adjustment)

Accounts Receivable	
45,600	

Allowance for Doubtful Accounts	
	150

Sales	
	150,000

### AGING SCHEDULE

Customer	Total	Not Yet Due	Number of Days Past Due			
			1-30	31-60	61-90	Over 90
R. Albert	\$ 500		\$ 300		\$ 100	\$ 100
G. Conner	600	\$ 600				
S. Davis	300		200	\$ 100		
B. Gordon	900	500			400	
T. Haig	800			500		300
Others	42,500	27,800	7,500	2,500	2,700	2,000
	<u>\$45,600</u>	<u>\$28,900</u>	<u>\$8,000</u>	<u>\$3,100</u>	<u>\$3,200</u>	<u>\$2,400</u>
<b>Estimated Percentage Uncollectible</b>		<u>2%</u>	<u>4%</u>	<u>10%</u>	<u>20%</u>	<u>40%</u>
<b>Total Estimated bad Debts</b>	<u>\$ 2,808</u>	<u>\$ 578</u>	<u>\$ 320</u>	<u>\$ 310</u>	<u>\$ 640</u>	<u>\$ 960</u>

Note: Required balance in Allowance account per aging schedule	\$2,808
Credit balance in Allowance account	<u>150</u>
Adjusting entry amount	<u>\$2,658</u>

## ILLUSTRATION 9-2 (Continued)

### ADJUSTING ENTRY TO RECORD BAD DEBTS EXPENSE

Bad Debts Expense.....	2,658
Allowance for Doubtful Accounts .....	2,658

### Balance of Selected Accounts at Year-End (After Adjustment)

Accounts Receivable	
45,600	

Allowance for Doubtful Accounts	
	150
	2,658
	<u>2,808</u>

Sales	
	150,000

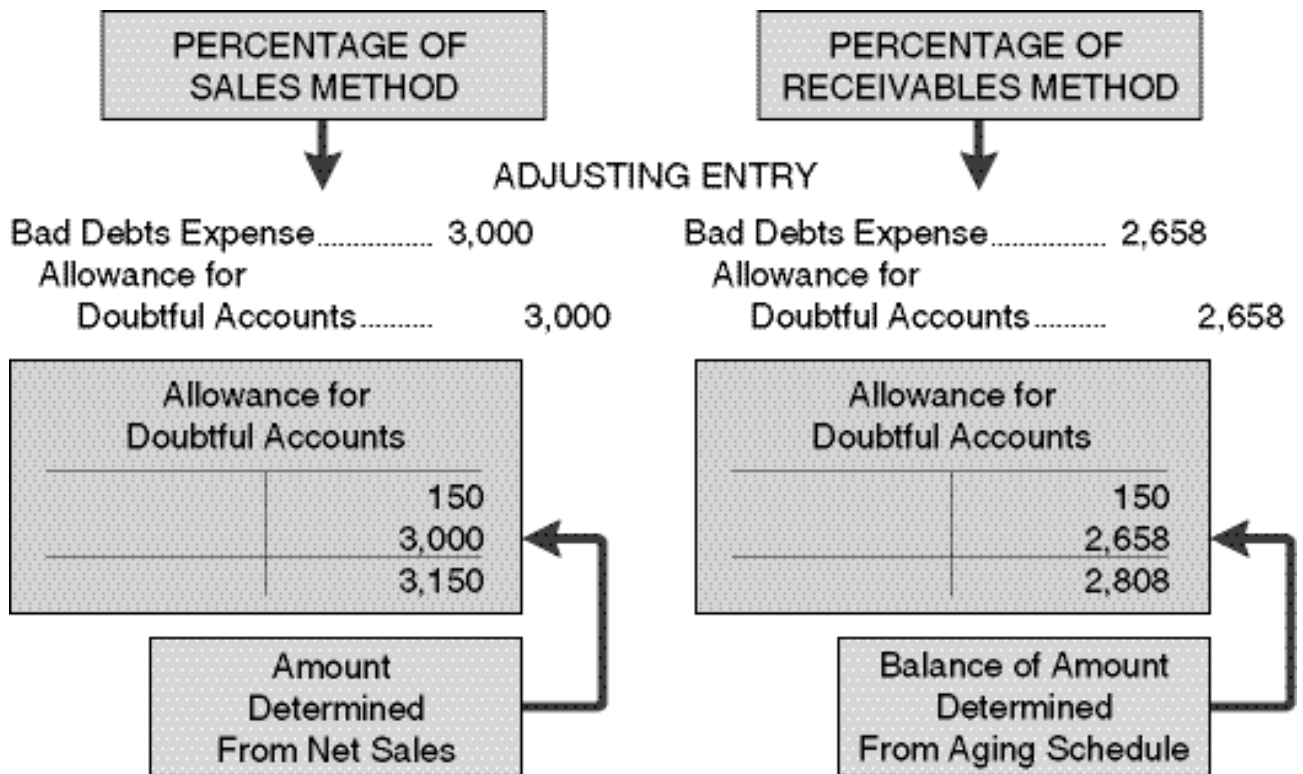
EMPHASIS ON BALANCE SHEET RELATIONSHIPS

ACCOUNTS  
RECEIVABLE  
\$45,600

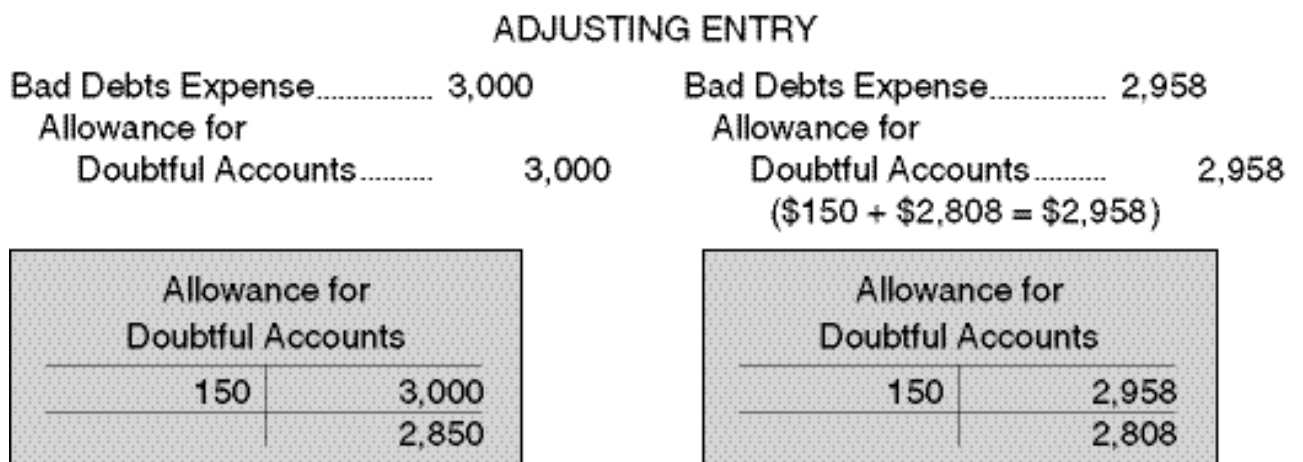


ALLOWANCE FOR  
DOUBTFUL ACCOUNTS  
\$2,808

### ILLUSTRATION 9-3 PERCENTAGE-OF-SALES VS. PERCENTAGE-OF-RECEIVABLES METHODS



If the Allowance account had a \$150 debit balance before adjustments, the adjusting entry using the percentage of sales method would not change. If the percentage of receivables method is used, the adjusting entry would have to take into consideration the debit balance in the Allowance account by adding the debit balance to the required Allowance account balance obtained from the aging schedule.



## ILLUSTRATION 9-4 SALE OF RECEIVABLES

### 1. SALE OF RECEIVABLES TO A FACTOR

**EXAMPLE:** A company sells \$800,000 of its receivables to a finance company that charges a fee of 2%.

Cash .....	784,000	
Service Charge Expense .....	16,000	
Accounts Receivable .....		800,000

### 2. NATIONAL CREDIT CARD SALES

**EXAMPLE:** A company purchases goods for \$500 using a VISA card. The retailer deposits the credit sales receipts in the bank and the bank charges a 3% fee.

Cash .....	485	
Service Charge Expense .....	15	
Sales .....		500

**ILLUSTRATION 9-5  
MATURITY DATE OF A NOTE**

DATE OF NOTE	TERMS OF NOTE STATED IN	MATURITY DATE
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MONTHS

July 1	3 Months	October 1
February 28	4 Months	June 30
September 15	2 Months	November 15

DAYS

August 11	60 Days	October 10												
	<table border="0"> <tr><td>Aug. (31-11)</td><td>20</td></tr> <tr><td>September</td><td>30</td></tr> <tr><td>October</td><td><u>10</u></td></tr> <tr><td></td><td><u>60</u></td></tr> </table>	Aug. (31-11)	20	September	30	October	<u>10</u>		<u>60</u>					
Aug. (31-11)	20													
September	30													
October	<u>10</u>													
	<u>60</u>													
March 4	90 Days	June 2												
	<table border="0"> <tr><td>Mar. (31-4)</td><td>27</td></tr> <tr><td>April</td><td>30</td></tr> <tr><td>May</td><td>31</td></tr> <tr><td>June</td><td><u>2</u></td></tr> <tr><td></td><td><u>90</u></td></tr> </table>	Mar. (31-4)	27	April	30	May	31	June	<u>2</u>		<u>90</u>			
Mar. (31-4)	27													
April	30													
May	31													
June	<u>2</u>													
	<u>90</u>													
May 14	120 Days	September 11												
	<table border="0"> <tr><td>May (31-14)</td><td>17</td></tr> <tr><td>June</td><td>30</td></tr> <tr><td>July</td><td>31</td></tr> <tr><td>August</td><td>31</td></tr> <tr><td>September</td><td><u>11</u></td></tr> <tr><td></td><td><u>120</u></td></tr> </table>	May (31-14)	17	June	30	July	31	August	31	September	<u>11</u>		<u>120</u>	
May (31-14)	17													
June	30													
July	31													
August	31													
September	<u>11</u>													
	<u>120</u>													

**ILLUSTRATION 9-6  
DISPOSITION OF NOTE RECEIVABLE**

**1. NOTE IS HONORED**

A \$20,000, 8%, 3-month note is collected at maturity.

Cash .....	20,400	
Notes Receivable .....		20,000
Interest Revenue .....		400
(\$20,000 × .08 × 3/12) = \$400		

**1. NOTE IS DISHONORED**

A \$20,000, 8%, 3-month note is dishonored at maturity.

Entry if collection is ultimately expected.

Accounts Receivable .....	20,400	
Notes Receivable .....		20,000
Interest Revenue .....		400

Entry if collection is not anticipated.

Allowance for Doubtful Accounts .....	20,000	
Notes Receivable .....		20,000