Sales and Accounts Receivable

Reporting and Analyzing Receivables

Study Objectives

- Identify the different types of receivables.
- Explain how accounts receivable are recognized in the accounts.
- Describe the methods used to account for bad debts.
- Compute the interest on notes receivable.
- Describe the entries to record the disposition of notes receivable.
- Explain the statement presentation of receivables.
- Describe the principles of sound accounts receivable management.
- Identify ratios to analyze a company's receivables.
- Describe methods to accelerate the receipt of cash from receivables.

Chapter Outline

Study Objective 1 - Identify the Different Types of Receivables

1. **Receivables** refer to amounts due from individuals and companies.
    a. Receivables are generated by the functions for which a company is in business to perform
    b. Receivables are claims that are expected to be collected in cash.
    c. Receivables represent one of a company's most liquid assets.
2. Receivables are frequently classified as:
    a. <u>Accounts receivable</u>
        i. A/R are generated by the functions for which a company is in business to perform
            1. Amounts owed by customers on account.
            2. Result from the sale of goods and services (often called **trade receivables**).
            3. Expected to be collected within 30 to 60 days.
            4. Usually the most significant type of claim held by a company.
    b. <u>Notes receivable</u>
        i. More formal debt that A/R involving a formal written promise to pay
            1. Recorded at net present value which involves interest being stated or imputed on the amount owed (see ii and iii below)
        ii. Represent claims for which formal instruments of credit are issued as evidence of debt.
        iii. Credit instrument normally requires payment of interest and extends for time periods of 60-90 days or longer.
        iv. May result from sale of goods and services (often called **trade receivables**).

c. Other receivables
    i. Nontrade receivables including interest receivable, loans to company officers, advances to employees, and income taxes refundable.
    ii. Generally classified and reported as separate items in the balance sheet.

Study Objective 2 - Explain how Accounts Receivable are Recognized in the Accounts

1. For a service organization, a receivable is recorded when service is provided on account.
2. Merchandisers record accounts receivable at the point of sale of merchandise on account.
3. Entry is recorded to increase both Sales and Accounts Receivable.
4. Receivable may be reduced by sales discount and/or sales return.

Study Objective 3 - Describe the Methods Used to Account for Bad Debts

1. Recognition of bad debt expense is about matching the probable bad debt to the period in which the credit sale (that may result in a bad debt) is made.
    a. This involves estimating bad debts and charging bad debts expense in the period of sale as opposed to the period in which the bad debt becomes apparent due to failure of collection efforts.
    b. This process involves the use of a "contra" (aka valuation account) called Allowance for Bad Debts in conjunction with the traditional expense account Bad Debts Expense
        i. Estimated credit losses are debited to **Bad Debt Expense** (or **Uncollectible Accounts Expense**) and credited to **Allowance for Bad Debts** in the period in which the sale occurs.
2. The Allowance Method Illustrated:
    a. The **allowance method** of accounting for bad debts involves estimating uncollectible accounts at the end of each period.
    b. Provides for matching of expenses and revenues on the income statement and ensures that receivables are stated at their **cash (net) realizable value** on the balance sheet.
    c. **Cash (net) realizable value** is the net amount of cash expected to be received; it excludes amounts that the company estimates it will not collect.
        i. That is to say that cash realizable value is equal to A/R less Allowance for Bad Debts (i.e. the net amount of cash expected to be received based on best estimates.
    d. Receivables are therefore reduced by estimated uncollectible receivables on the balance sheet through use of the allowance method.
    e. **The allowance method is required for financial reporting purposes when bad debts are material.** It has three essential features:
        i. Uncollectible accounts receivable are **estimated** and **matched against sales** in the same accounting period in which the sales occurred.
        ii. Estimated uncollectibles are recorded as an increase to Bad Debts Expense and an increase to Allowance for Doubtful Accounts (a contra asset account) through an adjusting entry at the end of each period.
        iii. Actual uncollectibles are debited to Allowance for Doubtful Accounts and credited to Accounts Receivable at the time the specific account is written off as uncollectible.
3. **Important characteristics** to understand about the **Allowance Method:**
    a. Allowance for Doubtful Accounts shows the estimated amount of claims on customers that are expected to become uncollectible in the future.
    b. The credit balance in the allowance account will absorb the specific write-offs when they occur.
    c. Allowance for Doubtful Accounts is a "real (balance sheet) account" is not closed at the end of the fiscal year.
    d. Bad Debts Expense is reported in the income statement as an operating expense.
    e. Each write-off should be approved in writing by authorized management personnel.

f. **Under the allowance method, every bad debt write-off is debited to the allowance account and not to Bad Debt Expense**.
   i. Note: The result of this system is that a write-off (i.e. the process of officially recognizing and recording a bad debt) affects only balance sheet accounts.
   ii. Cash realizable value in the balance sheet, therefore, remains the same.

g. When a customer pays after the account has been written off, two entries are required:
   i. The entry made in writing off the account is reversed to reinstate the customer's account.
   ii. The collection is journalized in the usual manner.

h. The recovery of a bad debt, like the write-off of a bad debt, affects only balance sheet account.

Illustrating the Allowance Method or Recognizing Bad Debts

Assume Hampson Furniture has credit sales of $1,200,000 in 2004, 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 is:

Dec. 31	**Bad Debts Expense**	**12,000**	
	Allowance for Doubtful Accounts		**12,000**
	(To record estimate of uncollectible accounts)		

Note that the expense is recognized in the period that the sale took place and that the "contra" account Allowance for BD is used to create a "net" value for A/R

Bad Debt Expense is a selling expense. This entry has no effect on cash flows. The Allowance for Doubtful Accounts is a contra asset account and is shown on the balance sheet as a reduction from accounts receivable. Therefore Hampson's balance sheet would report accounts receivable as follows:

Accounts receivable	**$200,000**	
Less: Allowance for doubtful accounts	**12,000**	**$188,000**

Assume that the vice-president of finance of Hampson Furniture on March 1, 2005, determines that a $500 balance owed by R. A. Ware will not be collected. 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)		

Note that the "write-off" has no effect on either the Income Statement (no expense or revenue account is affected) or the balance sheet (the net value of A/R) remains unchanged at 188,000.

Notice, the bad debt was written off to the allowance account not to the Bad Debts Expense account. Therefore, the write-off does not affect net income, nor does it affect net assets.

	Before Write-off	**After Write-off**
Accounts receivable	**$200,000**	**$199,500**
Allowance for doubtful accounts	**12,000**	**11,500**
Cash realizable value	**$188,000**	**$188,000**

If R. A. Ware pays Hampson the $500, two journal entries are required to record the collection:

July 1	**Accounts Receivable—R. A. Ware**	**500**	
	Allowance for Doubtful Accounts		**500**
	(To reverse write-off of R. A. Ware account)		
July 1	**Cash**	**500**	
	Accounts Receivable—R A. Ware		**500**
	(To record collection from R. A. Ware)		

If customer eventually pays, two steps are necessary:
1. Reinstate the receivable
2. Record the receipt of cash

Accounts Receivable and the 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 collection for possible future credit purposes.

1. **How do companies determine the proper value for the "Allowance for Bad Debts"**?
    a. In "real life," <u>companies must estimate the amount of expected uncollectible accounts</u> if they use the allowance method. There are two common methods employed for the estimation of uncollectible accounts (bad debts).
        i. <u>The Balance Sheet approach</u>:
            1. The **percentage of receivables basis**: management establishes a percentage relationship between the amount of receivables and expected losses from uncollectible accounts.
                a. A schedule is prepared in which customer balances are classified by the length of time they have been unpaid.
                b. Because of its emphasis on time, this schedule is often called an **aging schedule**, and the analysis of it is often called **aging the accounts receivable**.
                    i. After the accounts are arranged by age, the expected bad debt losses are determined by applying percentages, based on past experience, to the totals of each category.
                        1. For example:
                            a. 0-30 days 95%
                            b. 31-60 days 80%
                            c. 60-90 days 70%
                            d. Over 90 days 60%
                c. The estimated bad debts represent the existing customer claims expected to become uncollectible in the future.
                    i. This amount represents the **required balance** in Allowance for Doubtful Accounts at the balance sheet date.
                    ii. Accordingly**, the amount of the bad debts adjusting entry is the difference between the required balance and the existing balance in the allowance account**.
                    iii. Occasionally the allowance account will have a **debit balance** prior to adjustment because write-offs during the year have **exceeded** previous provisions for bad debts.
                        1. In such a case, the **debit balance is added to the required balance** when the adjusting entry is made.

4. **Direct write-off method** (only GAAP when receivables are immaterial in amount)
    a. While the "Allowance Method" is the only GAAP method for businesses with material amounts of A/R, those businesses with only minor (immaterial) A/R can use the Direct Charge (aka Direct Write-Off) method.
    b. Application of the Direct Write-Off (Direct Charge) method
        i. When a specific account is determined to be uncollectible, the loss is charged to Bad Debt Expense.
    c. Direct Charge method illustrated:

Assume that Warden Co. writes off M. E. Doran's $200 balance as uncollectible on December 12. The entry is:

Date	Account	Debit	Credit
Dec. 12	Bad Debts Expense	200	
	Accounts Receivable--M. E. Doran		200
	(To record write-off of M. E. Duran account)		

Note:
1. Bad debts are written of only when the determination is made that they are uncollectible.
2. There is no attempt to match the bad debt expense to the revenue that created it (the matching principal is violated).

d. Problems created by the Direct Charge method:
    i. Bad debts expense is often recorded in a period different from that in which the revenue was recorded (violation of matching principal).
    ii. No attempt is made to show accounts receivable in the balance sheet at the amount actually expected to be received (violation of full disclosure).
    iii. Use of the direct write-off method can reduce the usefulness of both the income statement and balance sheet.
e. Why is the Direct Charge method allowed at all?
    i. Proponents argue that because receivables are immaterial, the Direct Charge method can cause no material differences in the values presented in the financial statements
    ii. Ease of use

Study Objective 4 - Compute the Interest on Notes Receivable

1. Characteristics of **promissory notes**:
    a. A promissory note is a written promise to pay a specified amount of money on demand or at a definite time.
    b. In a promissory note, the party making the promise to pay is called the **maker.**
    c. The party to whom payment is to be made is called the **payee.**
        i. The payee may be specifically identified by name or may be designated simply as the bearer of the note.
    d. Notes receivable give the holder a stronger legal claim to assets than accounts receivable.
    e. Notes receivable are frequently accepted from customers who need to extend the payment of an outstanding account receivable, and they are often required from high-risk customers.
    f. Like accounts receivable, notes receivable can be readily sold to another party.
    g. Promissory notes are negotiable instruments.
2. Accounting for notes receivable:
    a. Notes must have three components:
        i. Maker
        ii. Payee
        iii. Due date (or on demand)
    b. All notes must have an interest component but that interest component may be either stated or imputed.
        i. If there is no interest amount stated on the note, interest must be "imputed" and the rate applicable to the maker based on the makers' credit worthiness.
3. Interest on Notes Receivable:
    a. The formula for computing interest is (PxRxT):
        i. Face Value of Note (**principle**) x Annual Interest **Rate** x **Time** (in terms of one year)
        ii. Interest is normally stated on a per annum basis and therefore the formula must be applied on a per annum basis (i.e. 3 months = $\frac{1}{4}$ year)
            1. 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.
        iii. Determining the Maturity date: When the maturity date is stated in days, the time factor is frequently the number of days divided by 360. For example, the maturity date of a 60-day note dated July 17 is determined as follows:

Term of note		60 days
July	31 days	
Date of note	17	
Remaining days in July:	14	
August	31	45
Maturity date, September		15

Remembering the Number of Days in a Given Month

30 days hath September, April, June, and November.
All the rest have 31, save February which has 28,
except in leap year when it has 29.

Interest Computations Illustrated

Terms of Note	Interest Computation	
$ 730, 18%, 120 days	$ 730 x 18% x 120/360	= $ 43.80
$1,000, 15%, 6 months	$1,000 x 15% x 6/12	= $ 75.00
$2,000, 12%, 1 year	$2,000 x 12% x 1/1	= $ 240.00

Although many financial institutions use 365 days in computing interest, problems in the text assume 360 days.

4. Accounting Entries for Notes Receivable:
   a. To illustrate the basic entry for notes receivable, the text uses Brent Company's $1,000, two-month, 12% promissory note dated May 1. Assume that the note was written to settle an open account. The entry for the receipt of the note by Wilma Company is as follows:

		Debit	Credit
May 1	Notes Receivable	1,000	
	Accounts Receivable—Brent Company.		1,000
	(To record acceptance of Brent Company note)		

1. The note receivable is recorded at its **face value**, the value shown on the face of the note.
2. No interest revenue is reported when the note is accepted because the revenue recognition principle does not recognize revenue until earned. Interest is earned (accrued) as time passes.
3. If a note is exchanged for cash, the entry is a debit to Notes Receivable and a credit to Cash in the amount of the loan.
4. Like accounts receivable, short-term notes receivable are reported at their **cash (net) realizable value**.
5. The notes receivable allowance account is Allowance for Doubtful accounts.

Study Objective 5 - Describe the Entries to Record the Disposition of Notes Receivable

1. A note is **honored** when it is paid in full at maturity
   a. If notes are held to their maturity date, both the face value of the note plus accrued interest must be recorded.

Accounting for an honored note paid in full at maturity

Assume that Wolder Co. lends Higley, Inc. $10,000 on June 1, accepting a 4-month, 9% interest note. If Wonder presents the note to Higley Inc. on October 1, the maturity date, the entry by Wolder to record the collection is:

		Debit	Credit
Oct. 1	**Cash**	**10,300**	
	Notes Receivable		**10,000**
	Interest Revenue		**300***
	(To record collection of Higley Inc. note and interest		

***$10,000 x .09 x 4/12 = $300**

If Wolder prepares financial statements as of September 30, the following adjusting entry would be made to accrue interest revenue.

		Debit	Credit
Sept. 30	**Interest Receivable**	**300**	
	Interest Revenue		**300**
	(To accrue 4 months' interest on Higley note)		

When interest has been accrued, the entry to record the honoring of Higley's note on October 1 is:

		Debit	Credit
Oct. 1	**Cash**	**10,300**	
	Notes Receivable		**10,000**
	Interest Receivable		**300**
	(To record collection of note at maturity)		

2. A **dishonored note** is a note that is not paid in full at maturity.
    a. If the maker of the note defaults or if the note is not paid in full at the maturity date (or on demand in the case of a demand note) the note is considered **dishonored**, two options are possible:
        i. If the lender expects that it will eventually be able to collect, the Notes Receivable account is **transferred to an Account Receivable for both the face value of the note and the interest due.**
        ii. If there is no hope of collection, the face value of the note should be written off.

Study Objective 6 - Explain the Balance Sheet Presentation of Receivables

1. Receivables are "Real Accounts" presented on the balance sheet in order of liquidity.
2. Each of the major types of receivables should be identified in the balance sheet or in the notes to the financial statements.
    a. Short-term receivables (other than Accounts Receivable) are reported in the current asset section of the balance sheet below short-term investments.
    b. Both the gross amount of receivables and the allowance for doubtful accounts should be reported.
    c. Notes receivable are listed before accounts receivable because notes are more easily converted to cash.
    d. Bad Debts Expense is reported under "Selling expenses" in the income statement.
    e. Interest Revenue is shown under "Other Revenues and Gains" in the non-operating section of the income statement.

- Note: If a company has significant risk of uncollectible accounts or other problems with receivables, it is required to discuss this possibility in the notes to the financial statements.

The advantages of having a note receivable rather than an account receivable are that:
1. Notes earn interest.
2. Notes receivable give the holder a stronger legal claim to assets than accounts receivable.
3. A note is a negotiable instrument and may be transferred to another party by endorsement

Study Objective 7 - Describe the Principles of Sound Accounts Receivable Management

1. Managing accounts receivable involves five steps:
    a. Determine to whom to extend credit.
        i. Risky customers might be required to provide letters of credit or bank guarantees.
        ii. Risky customers might be required to pay cash on delivery.
        iii. Ask potential customers for references from banks and suppliers and check the references.
        iv. Periodically check financial health of continuing customers.
    b. Establish a payment period.
        i. Determine a required payment period and communicate that policy to customers.
        ii. Make sure company's payment period is consistent with that of competitors.
    c. Monitor collections.
        i. Prepare accounts receivable aging schedule at least monthly.
        ii. Pursue problem accounts with phone calls, letters, and legal action if necessary.
    d. Evaluate the receivables balance.
        i. If a company has significant concentrations of credit risk, it is required to discuss this risk in the notes to its financial statements.
            1. A **concentration of credit risk** is a threat of nonpayment from a single customer or class of customers that could adversely affect the financial health of the company.
    e. Accelerate cash receipts from receivables when necessary. (see study objective 9 below)
        i. Many companies offer terms (2/10 net 30 etc) to accelerate payment by creditors.

All these steps are superfluous if the credit/collections department is not staffed with competent personnel

Study Objective 8 - Identify Ratios to Analyze a Company's Receivables

1. Liquidity is measured by how quickly certain assets can be converted into cash.
   a. The ratio used to assess the liquidity of the receivables is the **receivables turnover ratio**.
      i. The ratio measures the number of times, on average; receivables are collected during the period.
      ii. The receivables turnover ratio is computed by dividing net credit sales (net sales less cash sales) by the average gross accounts receivables during the year.
   b. A popular variant of the receivables turnover ratio is to convert it into an **average collection period** in terms of days. This is computed by dividing the receivables turnover ratio into 365 days.

Consider the following computations of Mckesson's receivables turnover ratio for 2000 and 2001:

2001		2000	
Net Credit Sales / Average Gross Receivables		**Net Credit Sales / Average Gross Receivables**	
$42,010 / ($3,863.1+$3,309.4)/2	**= 11.7**	**$36,687 / ($3,309.4+$2,732.6)/2**	**= 12.1**
365/11.7 = 31.2 days		**365/12.1 = 30.2 days**	

Study Objective 9 - Describe Methods to Accelerate the Receipt of Cash from Receivables

1. Two common expressions apply to the collection of receivables:
   a. Time is money—that is, waiting for the normal collection process costs money.
   b. 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.
2. Methods to Accelerate payment of receivables by creditors:
   a. Offer Terms (Sales discounts)for quick payment of goods (2/10, net 30)
      i. Known as sales discounts, these terms allow the creditor to take a 2% discount if the receivable is paid in the first 10 days of the month. Failure to take the discount costs the purchaser 36% on an annualized basis and is often an effective stimulus to generate rapid payment by creditors.
      ii. There are three reasons for the sale of receivables.
   b. Sell receivables: In recent years, for competitive reasons, sellers (retailers, wholesalers, and manufacturers) often have provided financing to purchasers of their goods. This process has generated increased sales but retarded the collection of cash.
      i. **Receivables may be sold 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.
      ii. **Another** 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.
         1. A common way to accelerate receivables collection is a sale to a factor.
            a. A **factor** is a finance company or a bank that buys receivables from businesses for a fee and then collects the payments directly from the customers.

b. Factoring arrangements vary widely, but typically the factor charges a commission of 1% to 3%.

Illustrating the Process of Factoring a Receivable

Assume 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. Hendredon makes the following journal entry:

Cash	588,000	
Service Charge Expense (2% x $600,000)	12,000	
Accounts Receivable		600,000
(To record the sale of accounts receivable)		

The service charge expense is recorded as a selling expense.

2. A retailer's acceptance of a national credit card is another form of selling—factoring—the receivable by the retailer.
   a. Approximately one billion credit cards were estimated to be in use recently. A common type of credit card is a national credit card such as Visa and MasterCard.
   b. Three parties are involved when national credit cards are used in making retail sales:
      i. The credit card issuer, who is independent of the retailer,
      ii. the retailer, and
      iii. the customer.
   c. There are several advantages of credit cards for the retailer:
      i. Issuer does credit investigation of customer.
      ii. Issuer maintains customer accounts.
      iii. Issuer undertakes collection process and absorbs any losses.
      iv. Retailer receives cash more quickly from credit card issuer.

3. Sales resulting from the use of Visa and MasterCard are considered cash sales by the retailer. Upon receipt of credit card sales slips from a retailer, the bank that issued the card immediately adds the amount to the seller's bank balance.

- 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 percent. The entry by Sondgeroth Music to record this transaction is:

Cash	970	
Service Charge Expense	30	
Sales		1,000
(To record Visa credit card sales)		

Sales and Accounts Receivable Review

- ✓ What are the different types of receivables? Why is it necessary to have them in different categories?
- ✓ Explain how accounts receivable are recognized in the accounts.
- ✓ What are the two methods used to account for bad debts? Which method is required by GAAP if bad debts are material?
- ✓ How is bad debt estimated when using the allowance method?
- ✓ What is the formula for computing interest on notes receivable?
- ✓ Describe the entries to record the disposition of notes receivable.
- ✓ Explain the statement presentation of receivables.
- ✓ What are the five steps in managing accounts receivable?
- ✓ Identify and compute ratios to analyze a company's receivables.
- ✓ What methods are used to accelerate the receipt of cash from receivables?

Reading Comprehension Check I **Name ________________**

Sales and Accounts Receivable

The term ________________ refers to amounts due from individuals and companies. ________________ are claims that are expected to be collected in cash. The management of ________________ is a very important activity for any company that sells goods on ________________. Receivables are important because they represent one of a company's most ________________ ________________. For many companies receivables are also one of the largest ________________.

The relative significance of a company's ________________ as a percentage of its ________________ differs depending on its industry, the time of year, whether it extends long-term financing, and its ________________ ________________. To reflect important differences among receivables, they are frequently classified as (1) ________________, (2) ________________, and (3) ________________.

________________ ________________ are amounts owed by customers on account. They result from the ________________ of ________________ and ________________. These receivables generally are expected to be collected within ________________ to ________________ days. They are the most significant type of claim held by the company.

________________ ________________ represent claims for which formal instruments of credit are issued as evidence of the ________________. The credit instrument normally requires the debtor to pay ________________ and extends for time periods of ________________ to ________________ days or longer. Notes and accounts receivable that result from sales transactions are often called ________________ ________________.

Solutions to Reading Comprehension Check I

Sales and Accounts Receivable

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 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**.

The relative significance of a company's **receivables** as a percentage of its **assets** differs depending on 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**, (2) **notes**, and (3) **other**.

Accounts **receivable** are amounts owed by customers on account. They result from the **sale** of **goods** and **services**. These receivables generally are expected to be collected within **30** to **60** days. They are the most significant type of claim held by the company.

Notes **receivable** represent claims for which formal instruments of credit are issued as evidence of the **debt**. The credit instrument normally requires the debtor to pay **interest** and extends for time periods of **60** to **90** days or longer. Notes and accounts receivable that result from sales transactions are often called **trade** **receivables**.

Reading Comprehension Check II Name ________________

Sales and Accounts Receivable

Credit may also be granted in exchange for a formal credit instrument known as a ________________ ________________. A promissory note is a written promise to pay a specified amount of money on ________________ or at a ________________ ________________. Promissory notes may be used when (1) individuals and companies________________ or ________________ money, (2) when the amount of the transaction and the credit period exceed ________________ ________________, and (3) in settlement of ________________ ________________.

In a promissory note, the party making the promise to pay is called the ________________; the party to whom payment is to be made is called the ________________. The payee may be specifically identified by name or may be designated simply as the ________________of the ________________.

Notes receivable give the holder a stronger ________________ ________________ to ________________ than ________________ ________________. Like accounts receivable, ________________ ________________ can be readily sold to another party. Promissory notes are ________________ ________________ (as are checks) which means that, when sold, they can be ________________ to another party by ________________.

Notes receivable are frequently accepted from customers who need to extend the payment of an outstanding ________________ ________________ and are often required from high-risk customers.

Solutions to Reading Comprehension Check II

Sales and Accounts Receivable

Credit may also be granted 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 when (1) 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 payee may be specifically identified by name or may be designated simply as the _____**bearer**_____ of the ______**note**______.

Notes receivable give the holder a stronger ________**legal**____________ __________**claim**________ to _______**assets**_______ than _____**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, they can be ____**transferred**_____ to another party by **endorsement**___.

Notes receivable are frequently accepted from customers who need to extend the payment of an outstanding ___**accounts**_______ _____**receivable**___ and are often required from high-risk customers.

Vocabulary Quiz **Name ______________**

Sales and Accounts Receivable

___________ 1. A note that is not paid in full at maturity.

___________ 2. Amounts owed by customers on account.

___________ 3. The party in a promissory note who is making the promise to pay.

___________ 4. A method of accounting for bad debts that involves expensing a particular account at the point it is determined to be uncollectible.

___________ 5. A measure of the liquidity of receivables, computed by dividing net credit sales by average gross receivables.

___________ 6. The average amount of time that a receivable is outstanding, calculated by dividing 365 days by the receivables turnover ratio.

___________ 7. Claims for which formal instruments of credit are issued as evidence of the debt.

___________ 8. A method of accounting for bad debts that involves estimating uncollectible accounts at the end of each period.

___________ 9. A finance company or bank that buys receivables from businesses for a fee and then collects the payments directly from the customers.

___________ 10. An analysis of customer balances by the length of time they have been unpaid.

Solutions to Vocabulary Quiz

Sales and Accounts Receivable

1. Dishonored note
2. Accounts receivable
3. Maker
4. Direct write-off method
5. Receivables turnover ratio
6. Average collection period
7. Promissory note
8. Allowance method
9. Factor
10. Aging the accounts receivable

Multiple Choice Quiz **Name _______________**

Sales and Accounts Receivable

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1. To ensure receivables are not overstated on the balance sheet, they are reported:
   a. at gross realizable value.
   b. at their cash (net) realizable value.
   c. less estimated uncollectible receivables.
   d. both b and c above.

2. Which of the following is the most liquid asset?
   a. Unearned revenue.
   b. Long-lived assets.
   c. Receivables.
   d. Intangibles.

3. Receivables are often classified as:
   a. accounts, notes, long-lived.
   b. accounts, notes, other.
   c. accounts, notes, inventory.
   d. none of the above.

4. All of the following are "other receivables" **except:**
   a. petty cash.
   b. interest receivable.
   c. income taxes refundable.
   d. advances to employees.

5. The method of accounting for bad debt expense, which conforms to GAAP is:
   a. direct write-off method.
   b. allowance method.
   c. both a and b.
   d. none of the above.

6. An aging of accounts receivable is used if bad debts are accounted for using:
   a. direct write-off method.
   b. allowance method with uncollectibles based on percentage of sales.
   c. allowance method with uncollectibles based on percentage
      of accounts receivable basis.
   d. none of the above.

7. When the allowance method is used and an account is subsequently written off as uncollectible, the following account is debited:
   a. bad debt expense.
   b. allowance for doubtful accounts.
   c. accounts receivable.
   d. both b and c.

8. The balance in the Allowance for Doubtful Accounts must be considered when using:
   a. direct write-off method.
   b. allowance method with uncollectibles based on percentage of sales.
   c. allowance method with uncollectibles based on percentage of accounts receivable.
   d. none of the above.

9. Notes receivable:
   a. earn interest.
   b. give the holder a stronger legal claim on assets than accounts receivable.
   c. are negotiable instruments.
   d. all of the above.

10. The due date on a 90-day promissory note dated June 1 is:
    a. August 29.
    b. August 30.
    c. August 31.
    d. September 1.

Solutions to Multiple Choice Quiz

Sales and Accounts Receivable

1. d
2. c
3. b
4. a
5. b
6. c
7. b
8. c
9. d
10. b

Exercise 1 - World Wide Web Research and Financial Statement Presentation Activity

Sales and Accounts Receivable

American Express launched The Travelers Cheque in 1891. Since that time, the company significantly expanded its range of products. Go to **www.americanexpress.com** to find the information needed to answer the following questions.

1. What are some of the benefits to businesses of accepting the American Express card?

2. Is Card Member Receivables of American Express increasing or decreasing?

3. What was the amount of the Reserve for Card Member Receivables for the two most current years?

4. Is the Bad Debt Expense of American Express increasing or decreasing?

Solutions: Information available on Wiley student website.

Note: The Wiley student website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 2 - World Wide Web Research and International Activity

Sales and Accounts Receivable

MasterCard International is a global payments company with one of the most recognized and respected brands in the world. With approximately 25,000 MasterCard, Cirrus and Maestro members worldwide, MasterCard serves consumers and businesses, both large and small, in 210 countries and territories. MasterCard is a leader in quality and innovation, offering a wide range of payment solutions in the virtual and traditional worlds. Visit MasterCard's Web Site at **www.MasterCard.com**.

1. List the suggested actions for individuals who are concerned about how to handle debt.

2. Discuss three ways MasterCard is working to help businesses that accept MasterCard.

3. List the four steps a business can take to prevent credit card fraud.

4. Discuss MasterCard's role as it relates to global business strategies.

Solutions: Information available on Wiley student website.

Note: The Wiley student website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 3 - World Wide Web Research and Accounts Receivable Activity

Sales and Accounts Receivable

On October 8, 1998 Citicorp and Travelers Group, Inc. merged, resulting in the formation of a new company called Citigroup. Citigroup offers customers a range of quality products and services unmatched in the financial services industry. Citigroup serves a broader spectrum of customers, in more places and by more means of access and delivery, than any other financial organization. Included in the Financial Data Supplement section of the annual report of Citigroup, is a schedule entitled "Details of Credit Loss Experience." Also, information regarding credit losses is found in the notes to the financial statements and management's discussion and analysis. Go to **www.citigroup.com** to find answers to the following questions.

1. Is the dollar amount of the allowance for credit losses account increasing or decreasing?

2. Would you expect the allowance to increase or decrease? Why or why not?

3. What percentage of the total loan portfolio is made up of consumer loans? What types of consumer loans are represented in the portfolio?

4. When are consumer loans generally written off? What method does Citigroup use to estimate uncollectible consumer loans?

Solutions: Information available on Wiley student website.

Note: The Wiley student website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 4 - World Wide Web Research and Factoring Activity

Sales and Accounts Receivable

Since 1979, American Receivable Corporation has provided small businesses with the financial resources they need to grow their business and effectively compete in the marketplace. Visit American Receivable at **www.amer-rec.com**, where you will find information to answer the following questions.

1. Describe the steps outlined in the flow chart "How Does Factoring Work?"

2. What is the advantage of factoring?

3. How can the additional working capital gained from factoring be put to use?

5. Define the following terms used in factoring:

    a. Advance rate

    b. Discount fee

    c. Factor

d. Reserve or holdback

Solutions: Information available on Wiley student website.

Note: The Wiley student website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 5 - Accounts Receivable Activity

Sales and Accounts Receivable

Michael's Bookshelf specializes in used, rare, and out-of-print books. The store has a large base of repeat customers who purchase books on 30-day accounts. At 15 days overdue, each customer gets a phone call from Michael requesting payment. Michael has experienced a high success rate with this collection effort. Michael's CPA is preparing year-end financial statements and has asked him for his estimate of uncollectible accounts. Michael has a balance of $65,000 in the Accounts Receivable account at the end of the year. He has analyzed his uncollectible accounts using an aging of the accounts receivable. He estimates that only 2.5 percent of his accounts receivable balance will not be collected. The Allowance for Doubtful Accounts has a credit balance of $210 in the trial balance.

1. Prepare the journal entry to record the bad debt expense at year end.

2. Show the balance sheet presentation of the receivable account.

3. What is the amount of bad debt expense that appears on the income statement? How is this amount classified?

4. What would be the justification, if any, for Michael to use the direct write-off method for accounting for uncollectible accounts?

Solutions:

1. Bad Debt Expense 1,415
Allowance for Doubtful Accounts 1,415
(To record estimate of uncollectible accounts)

2. <u>Current Assets</u>
Accounts Receivable $65,000
Less: Allowance for Uncollectible Accounts <u>1,625</u> $63,375

3. $1,415 is the total amount of bad debt expense. This amount is an operating expense shown in the income statement under selling expenses.

4. **Michael's bad debts are only 2.5 percent of his accounts receivable balance at the end of the period. If this amount is immaterial to total sales, Michael might justify not recording bad debts using the allowance method.**

Exercise 6 - Note Receivable Activity

Sales and Accounts Receivable

Jerry's Drafting Service closes its books on December 31. On October 1, Jerry accepts a $10,000 six-month, 12% note receivable from his customer, Heather Steel Company in exchange for an outstanding account receivable.

1. Record the receipt of the note receivable on October 1.

2. Record the accrual of interest on December 31

3. Record the payment of the note on April 1.

Solutions:

1. Oct. 1 Note Receivable 10,000
Accounts Receivable—Heather Steel Company 10,000
(To record acceptance of Heather Steel Company note)

2. Dec. 31 Interest Receivable 300
Interest Revenue 300
(To accrue 3 months' interest on Heather note)

3. Apr. 1 Cash 10,600
Note Receivable 10,000
Interest Receivable 300
Interest Revenue 300
(To record collection of Heather note and interest)

Exercise 7 - Credit Card Sales Activity

Sales and Accounts Receivable

Lee's Wildlife Art Gallery accepts national credit cards because he does not want the headaches and costs associated with collecting overdue accounts. During the month of December, Lee made a total of $32,000 in VISA First Bank Card sales. The service fee that First Bank charges Lee is 3 percent.

1. Record the entry by Lee's Wildlife Art Gallery to record the credit card sales transactions.

2. What are the advantages of accepting credit cards to Lee?

Solutions:

1.

Account	Debit	Credit
Cash	**31,040**	
Service Charge Expense	**960**	
Sales		**32,000**
(To record VISA credit card sales)		

2. Advantages of credit cards to Lee include:

- **Issuer does credit investigation of customer.**
- **Issuer maintains customer accounts.**
- **Issuer undertakes collection process and absorbs any losses.**
- **Retailer receives cash more quickly from credit card issuer.**

Exercise 8 - Allowance for Uncollectible Accounts, Accrual Accounting, and Communication Activity

Sales and Accounts Receivable

Your sister and brother-in-law have just opened a boutique specializing in shoes and accessories called "To Paputsi," which is Greek for "the shoe." The upscale shop will provide store credit for customers. The CPA who helped in setting up the books for the boutique included an account entitled Allowance for Doubtful Accounts. Your sister and brother-in-law do not want to use the allowance account, electing to write off bad debts as they are deemed to be uncollectible. Although you have had only one semester of accounting, you realize the importance of estimating bad debts and using the allowance account. Write a letter to your sister and brother-in-law explaining the importance of estimating bad debts and establishing the allowance account.

Solution:

Dear Sister and Brother-in-law:

Congratulations on the grand opening of your new boutique. "To Paputsi" will be a great success. I wish you luck!

You seem to be reluctant to use the account—Allowance for Doubtful Accounts. However, I think you should consider the matter further. The allowance account is used when estimating bad debts as opposed to writing them off after they have been determined to be uncollectible. The estimation method is the method that conforms to generally accepted accounting principles (GAAP). GAAP requires expenses to be matched with the revenues they help to produce. I am sure you can see that the extension of credit brings you more sales. However, you will incur bad debt expenses as a result of granting credit. Assume you sell a pair of shoes on account in August 1999. The customer does not make a payment in September or October. You call the customer early in November and are told that she will make a payment at the end of the month. On December 15 you notice that the customer has still not paid and call again. This time the customer promises she will pay no later than December 31. On January 2. 2000, you read in the paper that the customer has declared bankruptcy. At this time, it is to late to record the bad debt expense in the same period as the revenue. However, if it is reported in the year 2000, you are violating the matching principle and are not following GAAP.

Again, I wish you much success in the boutique. If you have further questions concerning this matter, I will be more than happy to help you.

With love,

Your sister