Chapter 8

Accounting for Receivables

STUDY OBJECTIVES

After studying this chapter, you should be able to:

1 Identify the different types of receivables.
2 Explain how companies recognize accounts receivable.
3 Distinguish between the methods and bases companies use to value accounts receivable.
4 Describe the entries to record the disposition of accounts receivable.
5 Compute the maturity date of and interest on notes receivable.
6 Explain how companies recognize notes receivable.
7 Describe how companies value notes receivable.
8 Describe the entries to record the disposition of notes receivable.
9 Explain the statement presentation and analysis of receivables.

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- Scan **Study Objectives**
- Read **Feature Story**
- Read **Preview**
- Read text and answer **Do it!** p. 366, p. 369, p. 373, p. 375
- Work **Comprehensive Do it!** p. 377
- Review **Summary of Study Objectives**
- Answer **Self-Study Questions**
- Complete **Assignments**

Feature Story

A DOSE OF CAREFUL MANAGEMENT KEEPS RECEIVABLES HEALTHY

"Sometimes you have to know when to be very tough, and sometimes you can give them a bit of a break," says Vivi Su. She's not talking about her children, but about the customers of a subsidiary of pharmaceutical company Whitehall-Robins (*www.whitehall-robins.com*), where she works as supervisor of credit and collections.

For example, while the company's regular terms are 1/15, n/30 (1% discount if paid within 15 days), a customer might ask for and receive a few days of grace and still get the discount. Or a customer might place orders above its credit limit, in which case, depending on its payment history and the circumstances, Ms. Su might authorize shipment of the goods anyway.

Nearly all of the company's sales come through the credit accounts Ms. Su manages. The process starts with the decision to grant a customer an account in the first place, Ms. Su explains. The sales rep gives the customer a credit application. "My department reviews this application very carefully; a customer needs to supply three good references, and we also run a check with a credit firm like Equifax. If we accept them, then based on their size and history, we assign a credit limit."

Once accounts are established, the company supervises them very carefully. "I get an aging report every single day," says Ms. Su.

"The rule of thumb is that we should always have at least 85% of receivables current—meaning they were billed less than 30 days ago," she continues. "But we try to do even better than that—I like to see 90%." Similarly, her guideline is never to have more than 5% of receivables at over 90 days. But long before that figure is reached, "we jump on it," she says firmly.

At 15 days overdue, Whitehall-Robins phones the client. Often there's a reasonable explanation for the delay—an invoice may have gone astray, or the payables clerk is away. "But if a customer keeps on delaying, and tells us several times that it'll only be a few more days, we know there's a problem," says Ms. Su. After 45 days, "I send a letter. Then a second notice is sent in writing. After the third and final notice, the client has 10 days to pay, and then I hand it over to a collection agency, and it's out of my hands."

Ms. Su knows that management of receivables is crucial to the profitability of Whitehall-Robins. "Receivables are generally the second-largest asset of any company (after its capital assets)," she points out. "So it's no wonder we keep a very close eye on them."

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Inside Chapter 8...

Preview of Chapter 8

As indicated in the Feature Story, receivables are a significant asset for many pharmaceutical companies. Because a significant portion of sales in the United States are done on credit, receivables are significant to companies in other industries as well. As a consequence, companies must pay close attention to their receivables and manage them carefully. In this chapter you will learn what journal entries companies make when they sell products, when they collect cash from those sales, and when they write off accounts they cannot collect.

The content and organization of the chapter are as follows.

Accounting for Receivables

Types of Receivables
- Accounts receivable
- Notes receivable
- Other receivables

Accounts Receivable
- Recognizing accounts receivable
- Valuing accounts receivable
- Disposing of accounts receivable

Notes Receivable
- Determining maturity date
- Computing interest
- Recognizing notes receivable
- Valuing notes receivable
- Disposing of notes receivable

Statement Presentation and Analysis
- Presentation
- Analysis

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TYPES OF RECEIVABLES

STUDY OBJECTIVE 1

Identify the different types of receivables.

The term **receivables** refers to amounts due from individuals and other companies. Receivables are claims that are expected to be collected in cash. They are frequently classified as (1) accounts receivable, (2) notes receivable, and (3) other receivables.

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

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

ETHICS NOTE

Companies report receivables from employees separately in the financial statements. The reason: Sometimes those assets are not the result of an "arm's-length" transaction.

Other receivables include nontrade receivables. Examples are 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 companies generally classify and report them as separate items in the balance sheet.

ACCOUNTS RECEIVABLE

Three accounting issues associated with accounts receivable are:

1. **Recognizing** accounts receivable.
2. **Valuing** accounts receivable.
3. **Disposing of** accounts receivable.

Recognizing Accounts Receivable

STUDY OBJECTIVE 2

Explain how companies recognize accounts receivable.

Recognizing accounts receivable is relatively straightforward. In Chapter 5 we saw how the sale of merchandise affects accounts receivable. To review, assume that Jordache Co. on July 1, 2010, 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.

July 1	Accounts Receivable—Polo Company	1,000	
	Sales		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.

The opportunity to receive a cash discount usually occurs when a manufacturer sells to a wholesaler or a wholesaler sells to a retailer. The selling company gives a discount in these situations either to encourage prompt payment or for competitive reasons.

Retailers rarely grant cash discounts to customers. In fact, when you use a retailer's credit card (Sears, for example), instead of giving a discount, the retailer charges interest on the balance due if not paid within a specified period (usually 25–30 days).

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.

To illustrate, assume that you use your JCPenney credit card to purchase clothing with a sales price of $300. JC Penney will make the following entry at the date of sale.

Accounts Receivable	300	
Sales		300
(To record sale of merchandise)		

A	=	L	+	SE
+300				
				+300 Rev

Cash Flows
no effect

JCPenney will send you a monthly statement of this transaction and any others that have occurred during the month. If you do not pay in full within 30 days, JCPenney adds an interest (financing) charge to the balance due. Although interest rates vary by region and over time, a common rate for retailers is 18% per year (1.5% per month).

The seller recognizes interest revenue when it adds financing charges. 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 to record interest revenue of $4.50 ($300 × 1.5%) is as follows.

Accounts Receivable	4.50	
Interest Revenue		4.50
(To record interest on amount due)		

A	=	L	+	SE
+4.50				
				+4.50 Rev

Cash Flows
no effect

Interest revenue is often substantial for many retailers.

Valuing Accounts Receivable

STUDY OBJECTIVE 3

Distinguish between the methods and bases companies use to value accounts receivable.

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. But determining the **amount** to report is sometimes difficult because some receivables will become uncollectible.

Each customer must satisfy the credit requirements of the seller before the credit sale is approved. Inevitably, though, some accounts receivable become uncollectible. For example, a customer may not be able to pay because of a decline in its sales revenue due to a downturn in the economy. Similarly, individuals may be laid off from their jobs or faced with unexpected hospital bills. Companies record credit losses as debits to **Bad Debts Expense** (or Uncollectible Accounts Expense). Such losses are a normal and necessary risk of doing business on a credit basis.

Two methods are used in accounting for uncollectible accounts: (1) the direct write-off method and (2) the allowance method. The following sections explain these methods.

DIRECT WRITE-OFF METHOD FOR UNCOLLECTIBLE ACCOUNTS

Under the **direct write-off method**, when a company determines a particular account to be uncollectible, it charges the loss to Bad Debts Expense. Assume, for example, that on December 12 Warden Co. writes off as uncollectible M. E. Doran's $200 balance. The entry is:

A	=	L	+	SE
				−200 Exp
−200				

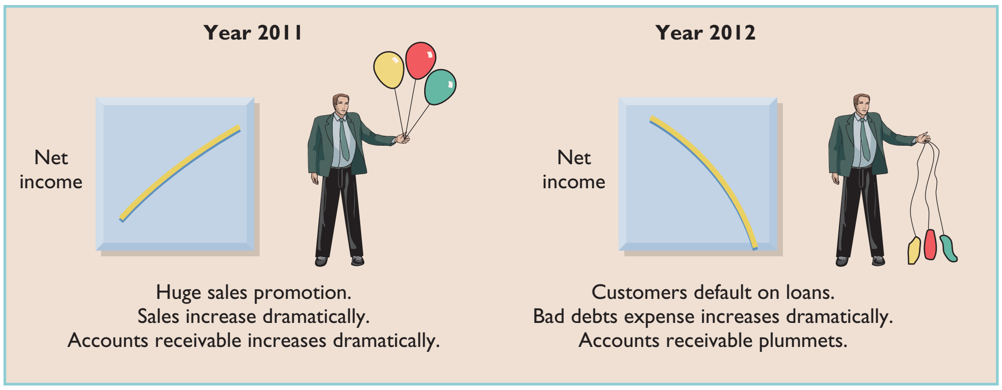
Cash Flows
no effect

Dec. 12	Bad Debts Expense	200	
	Accounts Receivable—M. E. Doran		200
	(To record write-off of M. E. Doran account)		

Under this method, Bad Debts Expense will show only **actual losses** from uncollectibles. The company will report accounts receivable at its gross amount.

Although this method is simple, its use can reduce the usefulness of both the income statement and balance sheet. Consider the following example. Assume that in 2011, 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. On campuses across the country it distributed one million computers with a selling price of $800 each. This increased Quick Buck's revenues and receivables by $800 million. The promotion was a huge success! The 2011 balance sheet and income statement looked great. Unfortunately, during 2012, nearly 40% of the customers defaulted on their loans. This made the 2012 income statement and balance sheet look terrible. Illustration 8-1 shows the effect of these events on the financial statements if the direct write-off method is used.

Illustration 8-1
Effects of direct write-off method



Under the direct write-off method, companies often record bad debts expense in a period different from the period in which they record the revenue. The method does not attempt to match bad debts expense to sales revenues in the income statement. Nor does the direct write-off method show accounts receivable in the balance sheet at the amount the company actually expects to receive. **Consequently, unless bad debts losses are 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 on the income statement. It also ensures that companies state receivables on the balance sheet at their cash (net) realizable value. **Cash (net) realizable value** is the net amount the company expects to receive in cash. It excludes amounts that the company estimates it will not collect. Thus, this method reduces receivables in the balance sheet by the amount of estimated uncollectible receivables.

GAAP requires the allowance method for financial reporting purposes when bad debts are material in amount. This method has three essential features:

HELPFUL HINT

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

1. Companies **estimate** uncollectible accounts receivable. They match this estimated expense **against revenues** in the same accounting period in which they record the revenues.
2. Companies debit estimated uncollectibles to Bad Debts Expense and credit them to Allowance for Doubtful Accounts (a contra-asset account) through an adjusting entry at the end of each period.
3. When companies write off a specific account, they debit actual uncollectibles to Allowance for Doubtful Accounts and credit that amount to Accounts Receivable.

Recording Estimated Uncollectibles. To illustrate the allowance method, assume that Hampson Furniture has credit sales of $1,200,000 in 2011. Of this amount, $200,000 remains uncollected at December 31. The credit manager estimates that $12,000 of these sales will be 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)		

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

Cash Flows
no effect

Hampson reports Bad Debts Expense in the income statement as an operating expense (usually as a selling expense). Thus, the estimated uncollectibles are matched with sales in 2011. Hampson records the expense in the same year it made the sales.

As Illustration 8-2 shows, the company deducts the allowance account from accounts receivable in the current assets section of the balance sheet.

Illustration 8-2
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	**12,000**	**188,000**
Merchandise inventory		310,000
Prepaid expense		25,000
Total current assets		$537,800

Allowance for Doubtful Accounts shows the estimated amount of claims on customers that the company expects 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 amount of $188,000 in Illustration 8-2 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.**

HELPFUL HINT
Cash realizable value is sometimes referred to as *accounts receivable (net).*

Recording the Write-Off of an Uncollectible Account. As described in the Feature Story, companies use various methods of collecting past-due accounts, such as letters, calls, and legal action. When they have exhausted all means of collecting a past-due account and collection appears impossible, the company should write off the account. In the credit card industry, for example, it is standard practice to write off accounts that are 210 days past due. To prevent premature or unauthorized write-offs, management should formally approve, in writing, each write-off. To maintain good internal control, companies should not give authorization to write off accounts to someone who also has daily responsibilities related to cash or receivables.

To illustrate a receivables write-off, assume that the financial vice president of Hampson Furniture authorizes a write-off of the $500 balance owed by R. A. Ware on March 1, 2012. The entry to record the write-off is:

A	=	L	+	SE
+500				
−500				

Cash Flows
no effect

Mar. 1	Allowance for Doubtful Accounts	500	
	Accounts Receivable—R. A. Ware		500
	(Write-off of R. A. Ware account)		

Bad Debts Expense does not increase when the write-off occurs. **Under the allowance method, companies debit every bad debt write-off to the allowance account rather than to Bad Debts Expense.** A debit to Bad Debts 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 the Allowance for Doubtful Accounts. After posting, the general ledger accounts will appear as in Illustration 8-3.

Illustration 8-3
General ledger balances after write-off

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

A write-off affects **only balance sheet accounts**—not income statement accounts. The write-off of the account reduces both Accounts Receivable and Allowance for Doubtful Accounts. Cash realizable value in the balance sheet, therefore, remains the same, as Illustration 8-4 shows.

Illustration 8-4
Cash realizable value comparison

	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**

Recovery of an Uncollectible Account. Occasionally, a company collects from a customer after it has written off the account as uncollectible. The company makes 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 had written off on March 1. These are the 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)		
July 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 above is a debit to Cash and a credit to Allowance for Doubtful Accounts for $500. 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, after R. A. Ware did pay, Accounts Receivable in the general ledger and Ware's account in the subsidiary ledger should show the collection for possible future credit purposes.

Bases Used for Allowance Method. To simplify the preceding explanation, we assumed we knew the amount of the expected uncollectibles. In "real life," companies must estimate that amount when they use the allowance method. Two bases are used to determine this amount: **(1) percentage of sales**, and **(2) percentage of receivables**. Both bases are generally accepted. The choice is a management decision. It depends on the relative emphasis that management wishes to give to expenses and revenues on the one hand or to cash realizable value of the accounts receivable on the other. The choice is whether to emphasize income statement or balance sheet relationships. Illustration 8-5 compares the two bases.

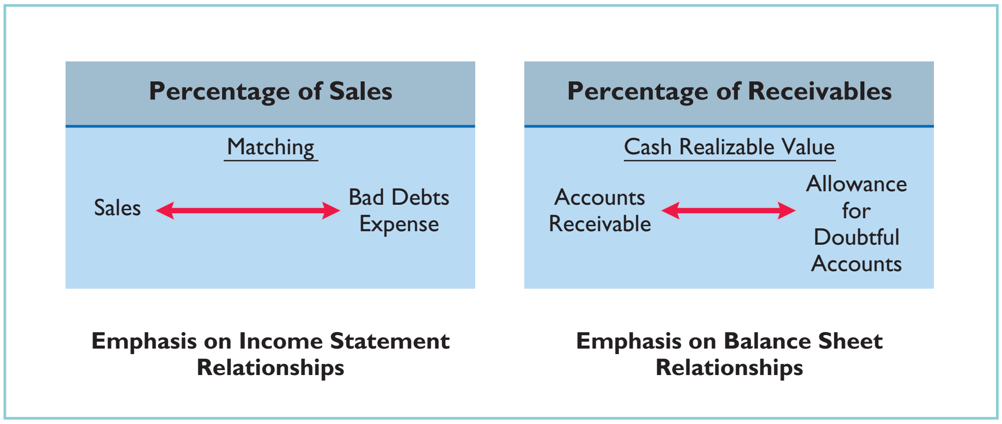


Illustration 8-5
Comparison of bases for estimating uncollectibles

The percentage-of-sales basis results in a better matching of expenses with revenues—an income statement viewpoint. The percentage-of-receivables basis produces the better estimate of cash realizable value—a balance sheet viewpoint. Under both bases, the company must determine its past experience with bad debt losses.

Percentage-of-Sales. In the **percentage-of-sales basis**, management estimates what percentage of credit sales will be uncollectible. This percentage is based on past experience and anticipated credit policy.

The company applies this percentage to either total credit sales or net credit sales of the current year. To illustrate, assume that Gonzalez Company elects to use the percentage-of-sales basis. It concludes that 1% of net credit sales will become uncollectible. If net credit sales for 2011 are $800,000, the estimated bad debts expense is $8,000 (1% × $800,000). The adjusting entry is:

A	=	L	+	SE
				−8,000 Exp
−8,000				

Cash Flows
no effect

Dec. 31	Bad Debts Expense	8,000	
	Allowance for Doubtful Accounts		8,000
	(To record estimated bad debts for year)		

After the adjusting entry is posted, assuming the allowance account already has a credit balance of $1,723, the accounts of Gonzalez Company will show the following:

Illustration 8-6
Bad debts accounts after posting

Bad Debts Expense				Allowance for Doubtful Accounts		
Dec. 31 Adj.	8,000				Jan. 1 Bal.	1,723
					Dec. 31 Adj.	8,000
					Dec. 31 Bal.	9,723

This basis of estimating uncollectibles emphasizes the matching of expenses with revenues. As a result, Bad Debts Expense will show a direct percentage relationship to the sales base on which it is computed. **When the company makes the adjusting entry, it disregards the existing balance in Allowance for Doubtful Accounts.** The adjusted balance in this account should be a reasonable approximation of the realizable value of the receivables. If actual write-offs differ significantly from the amount estimated, the company should modify the percentage for future years.

Percentage-of-Receivables. Under the **percentage-of-receivables basis**, management estimates what percentage of receivables will result in losses from uncollectible accounts. The company prepares an **aging schedule**, in which it classifies customer balances by the length of time they have been unpaid. Because of its emphasis on time, the analysis is often called **aging the accounts receivable**. In the opening story, Whitehall-Robins prepared an aging report daily.

After the company arranges the accounts by age, it determines the expected bad debt losses. It applies percentages based on past experience to the totals in each category. The longer a receivable is past due, the less likely it is to be collected. Thus, 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 that the estimated percentage uncollectible increases from 2 to 40% as the number of days past due increases.

Worksheet.xls

File Edit View Insert Format Tools Data Window Help

	A	B	C	D	E	F	G
1				Number of Days Past Due			
2			Not				
3	**Customer**	**Total**	**Yet Due**	**1–30**	**31–60**	**61–90**	**Over 90**
4	T. E. Adert	$ 600		$ 300		$ 200	$ 100
5	R. C. Bortz	300	$ 300				
6	B. A. Carl	450		200	$ 250		
7	O. L. Diker	700	500			200	
8	T. O. Ebbet	600			300		300
9	Others	36,950	26,200	5,200	2,450	1,600	1,500
10		$39,600	$27,000	$5,700	$3,000	$2,000	$1,900
11	Estimated Percentage Uncollectible		2%	4%	10%	20%	40%
12	Total Estimated Bad Debts	$ 2,228	$ 540	$ 228	$ 300	$ 400	$ 760
13							

Illustration 8-7
Aging schedule

HELPFUL HINT
The older categories have higher percentages because the longer an account is past due, the less likely it is to be collected.

Total estimated bad debts for Dart Company ($2,228) represent the amount of existing customer claims the company expects will become uncollectible in the future. This amount represents the **required balance** in Allowance for Doubtful Accounts at the balance sheet date. **The amount of the bad debt adjusting entry is the difference between the required balance and the existing balance in the allowance account.** If the trial balance shows Allowance for Doubtful Accounts with a credit balance of $528, the company will make an adjusting entry for $1,700 ($2,228 − $528), as shown here.

Dec. 31	Bad Debts 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 the adjusting entry is posted, the accounts of the Dart Company will show:

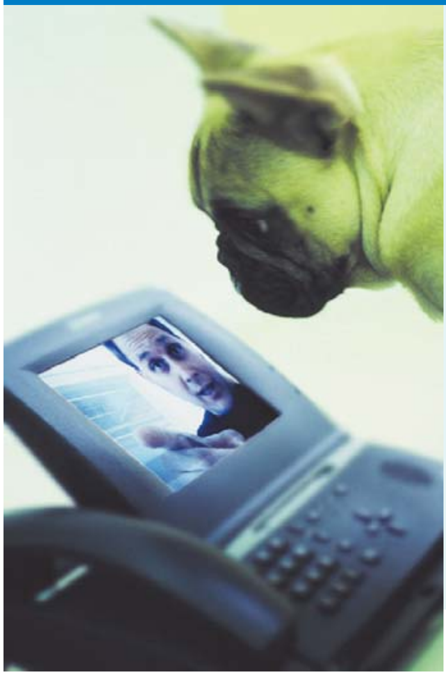
Bad Debts Expense			
Dec. 31 Adj.	**1,700**		

Allowance for Doubtful Accounts			
		Bal.	528
		Dec. 31 Adj.	**1,700**
		Bal.	2,228

Illustration 8-8
Bad debts accounts after posting

Occasionally the allowance account will have a **debit balance** prior to adjustment. This occurs when write-offs during the year have exceeded previous provisions 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 had been a $500 debit balance in the allowance account before adjustment, the adjusting entry would have been for $2,728 ($2,228 + $500) to arrive at a credit balance of $2,228. The percentage-of-receivables basis will normally result in the better approximation of cash realizable value.

INVESTOR 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 at least 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.

This reduction in bad debts 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?

before you go on...

Uncollectible Accounts Receivable

Do it! Brule Co. has been in business five years. The ledger at the end of the current year shows:

Accounts Receivable	$30,000 Dr.
Sales	$180,000 Cr.
Allowance for Doubtful Accounts	$2,000 Dr.

Bad debts are estimated to be 10% of receivables. Prepare the entry to adjust the Allowance for Doubtful Accounts.

Action Plan

- Report receivables at their cash (net) realizable value.
- 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

The following entry should be made to bring the balance in the Allowance for Doubtful Accounts up to a balance of $3,000 (0.1 × $30,000):

	Debit	Credit
Bad Debts Expense [(0.1 × $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, BE8-6, BE8-7, E8-3, E8-4, E8-5, E8-6,** and **Do it! 8-1.**

The Navigator

Disposing of Accounts Receivable

STUDY OBJECTIVE 4

Describe the entries to record the disposition of accounts receivable.

In the normal course of events, companies collect accounts receivable in cash and remove the receivables from the books. However, as credit sales and receivables have grown in significance, the "normal course of events" has changed. Companies now frequently sell their receivables to another company for cash, thereby shortening the cash-to-cash operating cycle.

Companies sell receivables for two major reasons. First, **they may be the only reasonable source of cash**. When money is tight, companies may not be able to borrow money in the usual credit markets. Or, if money is available, the cost of borrowing may be prohibitive.

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

SALE OF RECEIVABLES

A common sale of receivables is a sale to a factor. A **factor** is a finance company or bank that buys receivables from businesses and then collects the payments directly from the customers. Factoring is a multibillion dollar business.

Factoring arrangements vary widely. Typically the factor charges a commission to the company that is selling the receivables. This fee ranges from 1–3% of the amount of receivables purchased. To illustrate, assume that Hendredon Furniture factors $600,000 of receivables to Federal Factors. Federal Factors assesses a service charge of 2% of the amount of receivables sold. The journal entry to record the sale by Hendredon Furniture is as follows.

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 often sells its receivables, it records the service charge expense (such as that incurred by Hendredon) as selling expense. If the company infrequently sells receivables, it may report this amount in the "Other expenses and losses" section of the income statement.

ACCOUNTING ACROSS THE ORGANIZATION

How Does a Credit Card Work?

Most of you know how to *use* a credit card, but do you know what happens in the transaction and how the transaction is processed? Suppose that you use a Visa card to purchase some new ties at Nordstrom. The salesperson swipes your card, and the swiping machine reads the information on the magnetic strip on the back of the card. The salesperson then types in the amount of the purchase. The machine contacts the Visa computer, which routes the call back to the bank that issued your Visa card. The issuing bank verifies that the account exists, that the card is not stolen, and that you have not exceeded your credit limit. At this point, the slip is printed, which you sign.

Visa acts as the clearing agent for the transaction. It transfers funds from the issuing bank to Nordstrom's bank account. Generally this transfer of funds, from sale to the receipt of funds in the merchant's account, takes two to three days.

In the meantime, Visa puts a pending charge on your account for the amount of the tie purchase; that amount counts immediately against your available credit limit. At the end of the billing period, Visa sends you an invoice (your credit card bill) which shows the various charges you made, and the amounts that Visa expended on your behalf, for the month. You then must "pay the piper" for your stylish new ties.

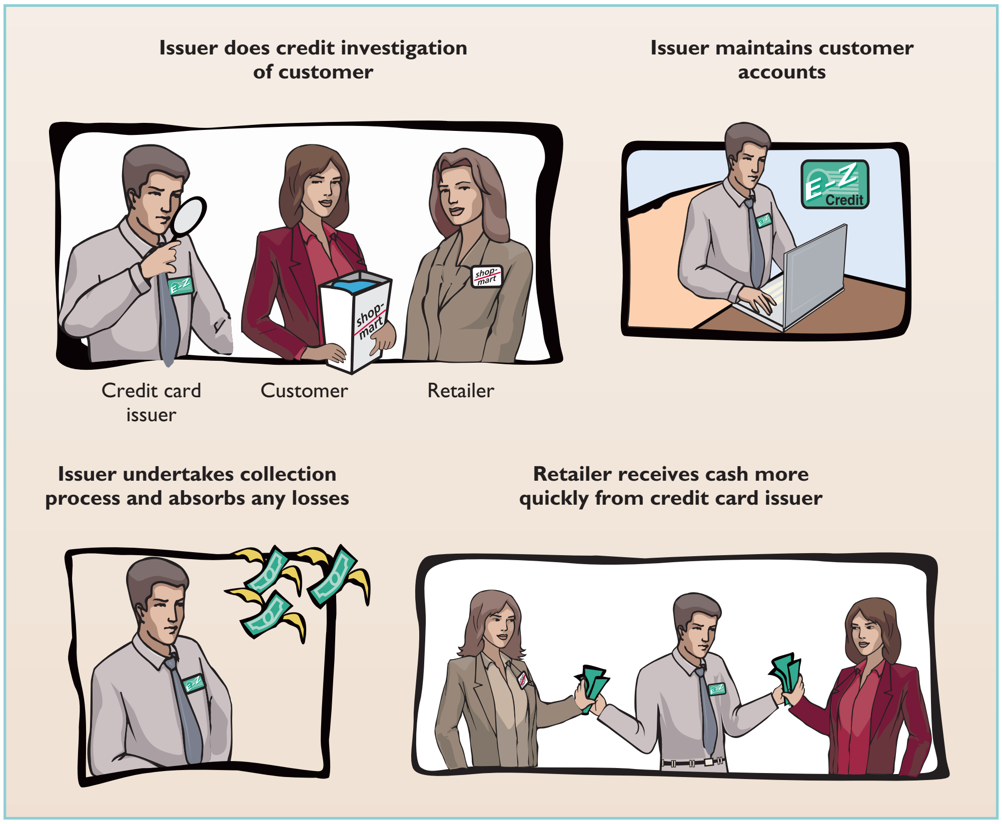
? Assume that Nordstrom prepares a bank reconciliation at the end of each month. If some credit card sales have not been processed by the bank, how should Nordstrom treat these transactions on its bank reconciliation?

CREDIT CARD SALES

Over one billion credit cards are in use in the United States—more than three credit cards for every man, woman, and child in this country. Visa, MasterCard, and American Express are the national credit cards that most individuals use. Three parties are involved when national credit cards are used in 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.

Illustration 8-9 shows the major advantages of national credit cards to the retailer. In exchange for these advantages, the retailer pays the credit card issuer a fee of 2–6% of the invoice price for its services.

Illustration 8-9
Advantages of credit cards to the retailer



Accounting for Credit Card Sales. The retailer generally considers sales from the use of national credit card sales as *cash sales*. The retailer must pay to the bank that issues the card a fee for processing the transactions. The retailer records the credit card slips in a similar manner as checks deposited from a cash sale.

To illustrate, Anita Ferreri purchases $1,000 of compact discs for her restaurant from Karen Kerr Music Co., using her Visa First Bank Card. First Bank charges a service fee of 3%. The entry to record this transaction by Karen Kerr Music is as follows.

A	=	L	+	SE
+970				
				−30 Exp
				+1,000 Rev

Cash Flows
+970

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

before you go on...

Do it! Mehl Wholesalers Co. has been expanding faster than it can raise capital. According to its local banker, the company has reached its debt ceiling. Mehl's suppliers (creditors) are demanding payment within 30 days of the invoice date for goods acquired, but Mehl's customers are slow in paying (60–90 days). As a result, Mehl has a cash flow problem.

Mehl needs $120,000 in cash to safely cover next Friday's payroll. Its balance of outstanding accounts receivables totals $750,000. What might Mehl do to alleviate this cash crunch? Record the entry that Mehl would make when it raises the needed cash.

Disposition of Accounts Receivable

Action Plan

- To speed up the collection of cash, sell receivables to a factor.
- Calculate service charge expense as a percentage of the factored receivables.

Solution

Assuming that Mehl Wholesalers factors $125,000 of its accounts receivable at a 1% service charge, it would make the following entry.

Cash	123,750	
Service Charge Expense	1,250	
Accounts Receivable		125,000
(To record sale of receivables to factor)		

Related exercise material: **BE8-8, E8-7, E8-8, E8-9,** and **Do it! 8-2.**

The Navigator

NOTES RECEIVABLE

Companies may also grant credit in exchange for a promissory note. A **promissory note** is a written promise to pay a specified amount of money on demand or at a definite time. Notes receivable give the payee a stronger legal claim to assets than accounts receivable. 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, or (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 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, Calhoun Company is the maker, Wilma Company is the payee. To Wilma Company, the promissory note is a note receivable; to Calhoun Company, it is a note payable.

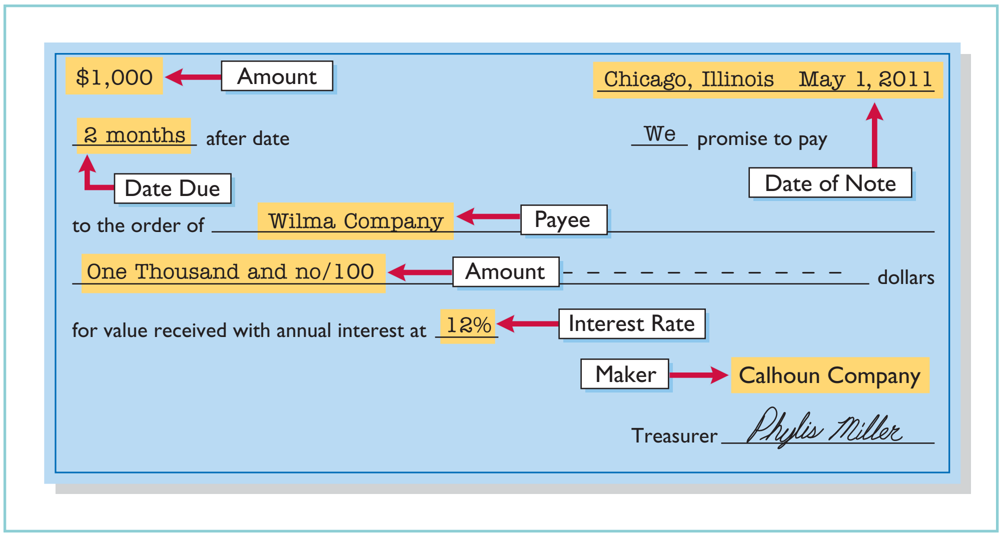


Illustration 8-10
Promissory note

HELPFUL HINT
Who are the two key parties to a note, and what entry does each party make when the note is issued?
Answer:
1. The maker, Calhoun Company, credits Notes Payable.
2. The payee, Wilma Company, debits Notes Receivable.

Like accounts receivable, notes receivable can be readily sold to another party. Promissory notes are negotiable instruments (as are checks), which means that they can be transferred to another party by endorsement.

Companies frequently accept notes receivable from customers who need to extend the payment of an account receivable. They often require such notes from high-risk customers. In some industries (such as the pleasure boat industry), all credit sales are supported by notes. The majority of notes originate from loans.

The basic issues in accounting for notes receivable are the same as those for accounts receivable:

1. **Recognizing** notes receivable.
2. **Valuing** notes receivable.
3. **Disposing of** notes receivable.

On the following pages, we will look at these issues. Before we do, we need to consider two issues that did not apply to accounts receivable: maturity date and computing interest.

Determining the Maturity Date

STUDY OBJECTIVE 5
Compute the maturity date of and interest on notes receivable.

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.

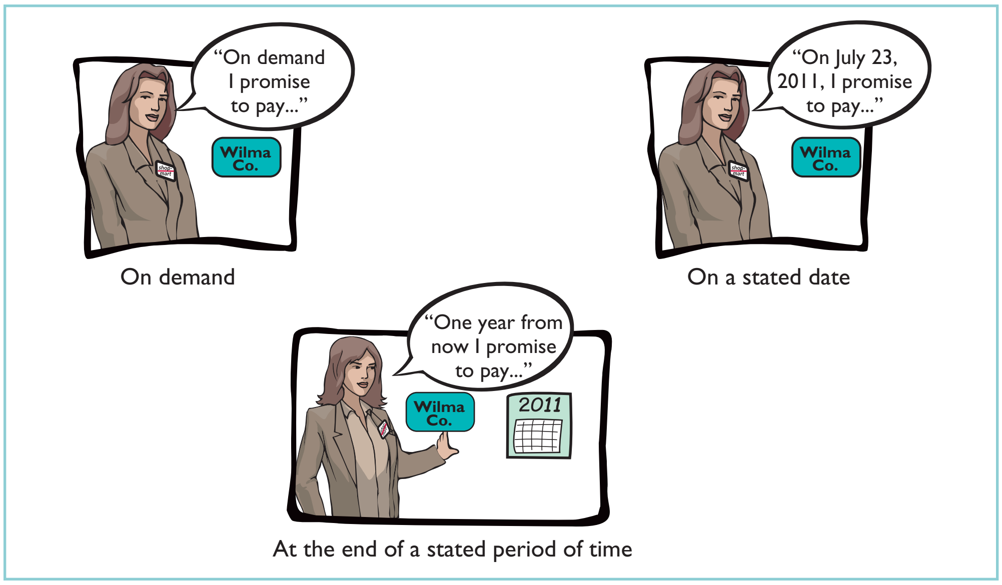
When the due date is stated in terms of days, you need to count the exact number of days to determine the maturity date. In counting, **omit the date the note is issued but include the due date**. For example, the maturity date of a 60-day note dated July 17 is September 15, computed as follows.

Illustration 8-11
Computation of maturity date

Term of note		60 days
July (31−17)	14	
August	31	45
Maturity date: September		**15**

Illustration 8-12 shows three ways of stating the maturity date of a promissory note.

Illustration 8-12
Maturity date of different notes



Computing Interest

As indicated in Chapter 3, the basic formula for computing interest on an interest-bearing note is:

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest

Illustration 8-13
Formula for computing interest

The interest rate specified in a note is an **annual** rate of interest. There are many different ways to calculate interest. The time factor in the formula in Illustration 8-13 expresses the fraction of a year that the note is outstanding. When the maturity date is stated in days, the time factor is often the number of days divided by 360. When the due date is stated in months, the time factor is the number of months divided by 12. Illustration 8-14 shows computation of interest for various time periods.

HELPFUL HINT
The interest rate specified is the *annual* rate.

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

Illustration 8-14
Computation of interest

The computation above assumed 360 days for the length of the year. Financial instruments actually use 365 days. In order to simplify calculations in our illustrations, we have assumed 360 days. *For homework problems, assume 360 days*.

Recognizing Notes Receivable

STUDY OBJECTIVE 6
Explain how companies recognize notes receivable.

To illustrate the basic entry for notes receivable, we will use the \$1,000, two-month, 12% promissory note on page 369. Assuming that Calhoun 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—Calhoun Company		1,000
	(To record acceptance of Calhoun Company note)		

A	=	L	+	SE
+1,000				
−1,000				

Cash Flows
no effect

The company records the note receivable at its **face value**, the amount shown on the face of the note. 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.

If a company lends money using a note, the entry is a debit to Notes Receivable and a credit to Cash in the amount of the loan.

Valuing Notes Receivable

STUDY OBJECTIVE 7
Describe how companies value notes receivable.

Valuing short-term notes receivable is the same as valuing accounts 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. The estimations involved in determining cash realizable value and in recording bad debts expense and the related allowance are done similarly to accounts receivable.

Disposing of Notes Receivable

STUDY OBJECTIVE 8

Describe the entries to record the disposition of notes receivable.

Notes may be held to their maturity date, at which time the maker must pay the face value plus accrued interest. Sometimes the maker of the note defaults and the payee must make an adjustment to the accounts. At other times the holder of the note speeds up the conversion to cash by selling the note receivable.

HONOR OF NOTES RECEIVABLE

A note is **honored** when its maker pays it in full at its maturity date. For an 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.

To illustrate, assume that Betty Co. lends Wayne Higley Inc. $10,000 on June 1, accepting a five-month, 9% interest-bearing note. Interest will be $375 ($10,000 × 9% × 5/12). The maturity value will be $10,375. To obtain payment, Betty Co. (the payee) must present the note either to Wayne Higley Inc. (the maker) or to the maker's designated agent, such as a bank. Assuming that Betty Co. presents the note to Wayne Higley Inc. on the maturity date, Betty Co.'s entry to record the collection is:

A = L + SE
+10,375
−10,000
+375 Rev
Cash Flows
+10,375

Nov. 1	Cash	10,375	
	Notes Receivable		10,000
	Interest Revenue		375
	(To record collection of Higley Inc. note)		

If Betty Co. prepares financial statements as of September 30, it must accrue interest. In this case, Betty Co. would make the adjusting entry shown below to record 4 months' interest ($300).

A = L + SE
+300
+300 Rev
Cash Flows
no effect

Sept. 30	Interest Receivable ($10,000 × 9% × 4/12)	300	
	Interest Revenue		300
	(To accrue 4 months' interest)		

When interest has been accrued, the company must credit Interest Receivable at maturity. In addition, since an additional month has passed, it must record one month of interest revenue. The entry by Betty Co. to record the honoring of the Wayne Higley Inc. note on November 1 is:

A = L + SE
+10,375
−10,000
−300
+75 Rev
Cash Flows
+10,375

Nov. 1	Cash	10,375	
	Notes Receivable		10,000
	Interest Receivable		300
	Interest Revenue ($10,000 × 9% × 1/12)		75
	(To record collection of note at maturity)		

In this case, Betty Co. credits Interest Receivable because the receivable was established in the adjusting entry of September 30.

DISHONOR OF NOTES RECEIVABLE

A **dishonored 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. Therefore the note holder usually transfers the Notes Receivable account to an Account Receivable.

To illustrate, assume that Wayne Higley Inc. on November 1 indicates that it cannot pay at the present time. The entry to record the dishonor of the note depends on whether Betty Co. expects eventual collection. If it does expect eventual collection, Betty Co. debits the amount due (face value and interest) on the note to Accounts Receivable. It would make the following entry at the time the note is dishonored (assuming no previous accrual of interest).

Nov. 1	Accounts Receivable—Wayne Higley Inc.	10,375	
	Notes Receivable		10,000
	Interest Revenue		375
	(To record the dishonor of Higley Inc. note)		

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

Cash Flows
no effect

If instead, on November 1, there is no hope of collection, the note holder would write off the face value of the note by debiting the Allowance for Doubtful Accounts. No interest revenue would be recorded because collection will not occur.

SALE OF NOTES RECEIVABLE

The accounting for the sale of notes receivable is recorded similarly to the sale of accounts receivable. The accounting entries for the sale of notes receivable are left for a more advanced course.

before you go on...

Do it!

Gambit Stores accepts from Leonard Co. a $3,400, 90-day, 12% note dated May 10 in settlement of Leonard's overdue account. (a) What is the maturity date of the note? (b) What is the entry made by Gambit at the maturity date, assuming Leonard pays the note and interest in full at that time?

Notes Receivable

Action Plan

- Count the exact number of days to determine the maturity date. Omit the date the note is issued, but include the due date.
- Determine whether interest was accrued. The entry here assumes that no interest has been previously accrued on this note.

Solution

(a) The maturity date is August 8, computed as follows.

Term of note:		90 days
May (31−10)	21	
June	30	
July	31	82
Maturity date: August		8

(b) The interest payable at the maturity date is $102, computed as follows.

Face × Rate × Time = Interest
$3,400 × 12% × 90/360 = $102

The entry recorded by Gambit Stores at the maturity date is:

Cash	3,502	
Notes Receivable		3,400
Interest Revenue		102
(To record collection of Leonard note)		

Related exercise material: **BE8-9, BE8-10, BE8-11, E8-10, E8-11, E8-12, E8-13,** and **Do it! 8-3.**

The Navigator

STATEMENT PRESENTATION AND ANALYSIS

Presentation

STUDY OBJECTIVE 9
Explain the statement presentation and analysis 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 appear in the current assets section of the balance sheet, below short-term investments. Short-term investments appear before receivables, because short-term investments are more liquid (nearer to cash). Companies report both the gross amount of receivables and the allowance for doubtful accounts.

In a multiple-step income statement, companies report bad debts expense and service charge expense as selling expenses in the operating expenses section. Interest revenue appears under "Other revenues and gains" in the nonoperating activities section of the income statement.

Analysis

Investors and corporate managers compute financial ratios to evaluate the liquidity of a company's accounts receivable. They use the **accounts receivable turnover ratio** to assess the liquidity of the receivables. This ratio measures the number of times, on average, the company collects accounts receivable during the period. It is computed by dividing net credit sales (net sales less cash sales) by the average net accounts receivable during the year. Unless seasonal factors are significant, average net accounts receivable outstanding can be computed from the beginning and ending balances of net accounts receivable.

For example, in 2008 Cisco Systems had net sales of $33,099 million for the year. It had a beginning accounts receivable (net) balance of $3,989 million and an ending accounts receivable (net) balance of $3,821 million. Assuming that Cisco's sales were all on credit, its accounts receivable turnover ratio is computed as follows.

Illustration 8-15
Accounts receivable turnover ratio and computation

Net Credit Sales	÷	Average Net Accounts Receivable	=	Accounts Receivable Turnover
$33,099	÷	$\frac{\$3,989 + \$3,821}{2}$	=	**8.5 times**

The result indicates an accounts receivable turnover ratio of 8.5 times per year. The higher the turnover ratio, the more liquid the company's receivables.

A variant of the accounts receivable turnover ratio that makes the liquidity even more evident is its conversion into an **average collection period** in terms of days. This is done by dividing the turnover ratio into 365 days. For example, Cisco's turnover of 8.5 times is divided into 365 days, as shown in Illustration 8-16, to obtain approximately 42.9 days. This means that it takes Cisco about 43 days to collect its accounts receivable.

Days in Year	÷	Accounts Receivable Turnover	=	Average Collection Period in Days
365 days	÷	8.5 times	=	**42.9 days**

Illustration 8-16
Average collection period for receivables formula and computation

Companies frequently use the average collection period to assess the effectiveness of a company's credit and collection policies. The general rule is that the collection period should not greatly exceed the credit term period (that is, the time allowed for payment).

before you go on...

Do it!

Analysis of Receivables

In 2011, Lebron James Company has 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 balances are considered in the computation.
- Review the formula to compute the average collection period in days.

Solution

(a)	Net credit sales	÷	Average net accounts receivable	=	Accounts receivable turnover
	$923,795	÷	$\dfrac{38{,}275 + 35{,}988}{2}$	=	24.9 times
(b)	Days in year	÷	Accounts receivable turnover	=	Average collection period in days
	365	÷	24.9 times	=	14.7 days

Related exercise material: **BE8-12, E8-14,** and **Do it! 8-4.**

The Navigator

Be sure to read
all about YOU
Should You Be Carrying Plastic?
on page 376 for information on how topics in this chapter apply to your personal life.

all about YOU

Should You Be Carrying Plastic?

Smart business people carefully consider their use of credit. They evaluate who they lend to, and how they finance their own operations. They know that getting overextended on credit can destroy their business.

Individuals need to evaluate their personal credit positions using the same thought processes used by business people. Some of you might consider the idea of not having a credit card a ridiculous proposition. But the reality is that the misuse of credit cards brings financial hardship to millions of Americans each year. Credit card companies aggressively market their cards with images of glamour and happiness. But there isn't much glamour in paying an 18% to 21% interest rate, and there is very little happiness to be found in filing for personal bankruptcy.

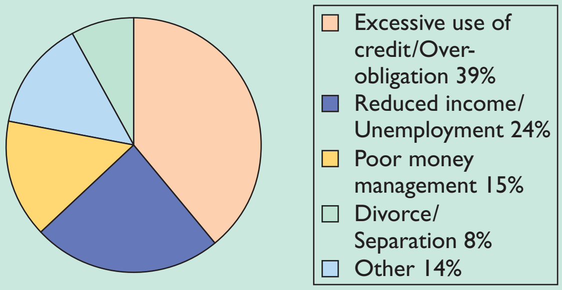
Some Facts

* According to data from the U.S. Census Bureau, there were 159 million credit cardholders in the United States in 2000 and 173 million in 2006; that number is projected to grow to 181 million Americans by 2010.
* In 2006, the U.S. Census Bureau determined that there were nearly 1.5 billion credit cards in use in the U.S. A stack of all those credit cards would reach more than 70 miles into space—and be almost as tall as 13 Mount Everests.
* In a recent year, Americans charged more than $1 trillion in purchases with their credit cards. That was more than they spent in cash.
* Credit card defaults—the failure to make a payment on a debt by the due date—sprouted in February 2009 to a 20-year-high.
* 74% of monthly college spending is with cash and debit cards. Only 7% is with credit cards.
* The average college graduate has nearly $20,000 in debt; average credit card debt has increased 47% between 1989 and 2004 for 25- to 34-year-olds and 11% for 18- to 24-year-olds. Nearly one in five 18- to 24-year-olds is in "debt hardship," up from 12% in 1989.
* Foreclosure filings nationwide soared 30% in January 2009 over the same month in the previous year. Nevada, California, and Florida had the highest foreclosure rates. One in every 440 U.S. homes received a foreclosure filing in February 2009.

About the Numbers

Presented below is a chart that shows the major causes of personal financial problems. Note the excessive use of credit, which is cited as the number-one cause. This often translates into addiction to credit cards.

Causes of Personal Financial Problems



Source: Debt Solutions of America, *www.becomedebtfree.com* (accessed May 2006).

What Do You Think?

Should you cut up your credit card(s)?

YES: Americans are carrying huge personal debt burdens. Credit cards encourage unnecessary, spontaneous expenditures. The interest rates on credit cards are extremely high, which causes debt problems to escalate exponentially.

NO: Credit cards are a necessity for transactions in today's economy. In fact, many transactions are difficult or impossible to carry out without a credit card. People should learn to use credit cards responsibly.

Sources: Debtsmart, *www.debtsmart.com/pages/debt_stats.html*; *New York Times*, February 23, 2009; Demos.org, "The Economic State of Young America," May 2008.

The authors' comments on this situation appear on page 395.

Comprehensive *Do it!*

The following selected transactions relate to Falcetto Company.

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.
	12	Accepted Juno Company's $20,000, 6-month, 12% note for balance due.
	13	Made Falcetto Company credit card sales for $13,200.
	15	Made Visa credit card sales totaling $6,700. A 3% 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 Falcetto Company credit card sales and added finance charges of 1.5% to the remaining balances.
May	10	Wrote off as uncollectible $16,000 of accounts receivable. Falcetto uses the percentage-of-sales basis to estimate bad debts.
June	30	Credit sales recorded during the first 6 months total $2,000,000. The bad debt percentage is 1% of credit sales. At June 30, the balance in the allowance account is $3,500.
July	16	One of the accounts receivable written off in May was from J. Simon, who pays the amount due, $4,000, in full.

Instructions

Prepare the journal entries for the transactions.

Solution to Comprehensive *Do it!*

Mar. 1	Accounts Receivable—Potter	20,000	
	Sales		20,000
	(To record sales on account)		
11	Cash	19,600	
	Sales Discounts (2% × $20,000)	400	
	Accounts Receivable—Potter		20,000
	(To record collection of accounts receivable)		
12	Notes Receivable	20,000	
	Accounts Receivable—Juno		20,000
	(To record acceptance of Juno Company note)		
13	Accounts Receivable	13,200	
	Sales		13,200
	(To record company credit card sales)		
15	Cash	6,499	
	Service Charge Expense (3% × $6,700)	201	
	Sales		6,700
	(To record credit card sales)		
Apr. 11	Cash	7,840	
	Service Charge Expense (2% × $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)		
	Accounts Receivable [($13,200 − $8,200) × 1.5%]	75	
	Interest Revenue		75
	(To record interest on amount due)		

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 debts expense.
- Ignore any balance in the allowance account under the percentage-of-sales basis. Recognize the balance in the allowance account under the percentage-of-receivables basis.
- Record write-offs of accounts receivable only in balance sheet accounts.

May 10	Allowance for Doubtful Accounts	16,000	
	Accounts Receivable		16,000
	(To record write-off of accounts receivable)		
June 30	Bad Debts Expense ($2,000,000 × 1%)	20,000	
	Allowance for Doubtful Accounts		20,000
	(To record estimate of uncollectible accounts)		
July 16	Accounts Receivable—J. Simon	4,000	
	Allowance for Doubtful Accounts		4,000
	(To reverse write-off of accounts receivable)		
	Cash	4,000	
	Accounts Receivable—J. Simon		4,000
	(To record collection of accounts receivable)		

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SUMMARY OF STUDY OBJECTIVES

WILEY PLUS

1 **Identify the different types of receivables.** Receivables are frequently classified as (1) accounts, (2) notes, and (3) other. Accounts receivable are amounts customers owe on account. Notes receivable are claims for which lenders issue formal instruments of credit as proof of the debt. Other receivables include nontrade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable.

2 **Explain how companies recognize accounts receivable.** Companies record accounts receivable at invoice price. They are reduced by sales returns and allowances. Cash discounts reduce the amount received on accounts receivable. When interest is charged on a past due receivable, the company adds this interest to the accounts receivable balance and recognizes it as interest revenue.

3 **Distinguish between the methods and bases companies use to value accounts receivable.** There are two methods of accounting for uncollectible accounts: the allowance method and the direct write-off method. Companies may use either the percentage-of-sales or the percentage-of-receivables basis to estimate uncollectible accounts using the allowance method. The percentage-of-sales basis emphasizes the expense recognition principle. The percentage-of-receivables basis emphasizes the cash realizable value of the accounts receivable. An aging schedule is often used with this basis. Unless bad debt losses are insignificant, the direct write-off method is not acceptable for financial reporting purposes.

4 **Describe the entries to record the disposition of accounts receivable.** When a company collects an account receivable, it credits Accounts Receivable. When a company sells (factors) an account receivable, a service charge expense reduces the amount received.

5 **Compute the maturity date of and interest on notes receivable.** For a note stated in months, the maturity date is found by counting the months from the date of issue. For a note stated in days, the number of days is counted, omitting the issue date and counting the due date. The formula for computing interest is: Face value × Interest rate × Time.

6 **Explain how companies recognize notes receivable.** Companies record notes receivable at face value. In some cases, it is necessary to accrue interest prior to maturity. In this case, companies debit Interest Receivable and credit Interest Revenue.

7 **Describe how companies value notes receivable.** As with accounts receivable, companies report notes receivable at their cash (net) realizable value. The notes receivable allowance account is the Allowance for Doubtful Accounts. The computation and estimations involved in valuing notes receivable at cash realizable value, and in recording the proper amount of bad debts expense and related allowance are similar to those for accounts receivable.

8 **Describe the entries to record the disposition of notes receivable.** Notes can be held to maturity. At that time the face value plus accrued interest is due, and the note is removed from the accounts. In many cases, the holder of the note speeds up the conversion by selling the receivable to another party (a factor). In some situations, the maker of the note dishonors the note (defaults), in which case the company transfers the note and accrued interest to an account receivable or writes off the note.

9 **Explain the statement presentation and analysis of receivables.** Companies should identify in the balance sheet or in the notes to the financial statements each major type of receivable. Short-term receivables are considered current assets. Companies report the gross amount of receivables and the allowance for doubtful accounts. They report bad debts and service charge expenses in the multiple-step income statement as operating (selling) expenses; interest revenue appears under other revenues and gains in the nonoperating activities section of the statement. Managers and investors evaluate accounts receivable for liquidity by computing a turnover ratio and an average collection period.

The Navigator

GLOSSARY

Accounts receivable Amounts owed by customers on account. (p. 358).

Accounts receivable turnover ratio A measure of the liquidity of accounts receivable; computed by dividing net credit sales by average net accounts receivable. (p. 374).

Aging the accounts receivable The analysis of customer balances by the length of time they have been unpaid. (p. 364).

Allowance for Doubtful Accounts An account that shows the estimated amount of claims on customers that the company expects will become uncollectible in the future. (p. 362).

Allowance method A method of accounting for bad debts that involves estimating uncollectible accounts at the end of each period. (p. 361).

Average collection period The average amount of time that a receivable is outstanding; calculated by dividing 365 days by the accounts receivables turnover ratio. (p. 375).

Bad Debts Expense An expense account to record uncollectible receivables. (p. 360).

Cash (net) realizable value The net amount a company expects to receive in cash. (p. 361).

Direct write-off method A method of accounting for bad debts that involves expensing accounts at the time they are determined to be uncollectible. (p. 360).

Dishonored note A note that is not paid in full at maturity. (p. 373).

Factor A finance company or bank that buys receivables from businesses and then collects the payments directly from the customers. (p. 367).

Maker The party in a promissory note who is making the promise to pay. (p. 369).

Notes receivable Claims for which formal instruments of credit are issued as proof of the debt. (p. 358).

Other receivables Various forms of nontrade receivables, such as interest receivable and income taxes refundable. (p. 358).

Payee The party to whom payment of a promissory note is to be made. (p. 369).

Percentage-of-receivables basis Management estimates what percentage of receivables will result in losses from uncollectible accounts. (p. 364).

Percentage-of-sales basis Management estimates what percentage of credit sales will be uncollectible. (p. 364).

Promissory note A written promise to pay a specified amount of money on demand or at a definite time. (p. 369).

Receivables Amounts due from individuals and other companies. (p. 358).

Trade receivables Notes and accounts receivable that result from sales transactions. (p. 358).

SELF-STUDY QUESTIONS

Answers are at the end of the chapter.

(SO 1) **1.** Receivables are frequently classified as:
- **a.** accounts receivable, company receivables, and other receivables.
- **b.** accounts receivable, notes receivable, and employee receivables.
- **c.** accounts receivable and general receivables.
- **d.** accounts receivable, notes receivable, and other receivables.

(SO 2) **2.** Buehler Company on June 15 sells merchandise on account to Chaz Co. for $1,000, terms 2/10, n/30. On June 20, Chaz Co. returns merchandise worth $300 to Buehler Company. On June 24, payment is received from Chaz Co. for the balance due. What is the amount of cash received?
- **a.** $700.
- **b.** $680.
- **c.** $686.
- **d.** None of the above.

(SO 3) **3.** Which of the following approaches for bad debts is best described as a balance sheet method?
- **a.** Percentage-of-receivables basis.
- **b.** Direct write-off method.
- **c.** Percentage-of-sales basis.
- **d.** Both a and b.

4. Hughes Company has a credit balance of $5,000 in its Allowance for Doubtful Accounts before any adjustments are made at the end of the year. Based on review and aging of its accounts receivable at the end of the year, Hughes estimates that $60,000 of its receivables are uncollectible. The amount of bad debts expense which should be reported for the year is: (SO 3)
- **a.** $5,000.
- **b.** $55,000.
- **c.** $60,000.
- **d.** $65,000.

5. Use the same information as in question 4, except that Hughes has a debit balance of $5,000 in its Allowance for Doubtful Accounts before any adjustments are made at the end of the year. In this situation, the amount of bad debt expense that should be reported for the year is: (SO 3)
- **a.** $5,000.
- **b.** $55,000.
- **c.** $60,000.
- **d.** $65,000.

6. Net sales for the month are $800,000, and bad debts are expected to be 1.5% of net sales. The company uses the percentage-of-sales basis. If the Allowance for Doubtful Accounts has a credit balance of $15,000 before adjustment, what is the balance after adjustment? (SO 3)
- **a.** $15,000.
- **b.** $27,000.
- **c.** $23,000.
- **d.** $31,000.

(SO 3) **7.** In 2011, Roso Carlson Company had net credit sales of $750,000. On January 1, 2011, Allowance for Doubtful Accounts had a credit balance of $18,000. During 2011, $30,000 of uncollectible accounts receivable were written off. Past experience indicates that 3% of net credit sales become uncollectible. What should be the adjusted balance of Allowance for Doubtful Accounts at December 31, 2011?

a. $10,050. **c.** $22,500.
b. $10,500. **d.** $40,500.

(SO 3) **8.** An analysis and aging of the accounts receivable of Prince Company at December 31 reveals the following data.

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

The cash realizable value of the accounts receivable at December 31, after adjustment, is:

a. $685,000. **c.** $800,000.
b. $750,000. **d.** $735,000.

(SO 6) **9.** One of the following statements about promissory notes is incorrect. The *incorrect* statement is:

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 often required from high-risk customers.

(SO 4) **10.** Which of the following statements about Visa credit card sales is *incorrect*?

a. The credit card issuer makes the credit investigation of the customer.
b. The retailer is not involved in the collection process.
c. Two parties are involved.
d. The retailer receives cash more quickly than it would from individual customers on account.

(SO 4) **11.** Blinka 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 Blinka Retailers will include a credit to Sales of $50,000 and a debit(s) to:

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

12. Foti Co. accepts a $1,000, 3-month, 12% promissory note in settlement of an account with Bartelt Co. The entry to record this transaction is as follows. (SO 6)

a.	Notes Receivable	1,030	
	Accounts Receivable		1,030
b.	Notes Receivable	1,000	
	Accounts Receivable		1,000
c.	Notes Receivable	1,000	
	Sales		1,000
d.	Notes Receivable	1,020	
	Accounts Receivable		1,020

13. Ginter Co. holds Kolar Inc.'s $10,000, 120-day, 9% note. The entry made by Ginter Co. when the note is collected, assuming no interest has been previously accrued, is: (SO 8)

a.	Cash	10,300	
	Notes Receivable		10,300
b.	Cash	10,000	
	Notes Receivable		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

14. Accounts and notes receivable are reported in the current assets section of the balance sheet at: (SO 9)

a. cash (net) realizable value
b. net book value.
c. lower-of-cost-or-market value.
d. invoice cost.

15. Oliveras Company had net credit sales during the year of $800,000 and cost of goods sold of $500,000. The balance in accounts receivable at the beginning of the year was $100,000, and the end of the year it was $150,000. What were the accounts receivable turnover ratio and the average collection period in days? (SO 9)

a. 4.0 and 91.3 days.
b. 5.3 and 68.9 days.
c. 6.4 and 57 days.
d. 8.0 and 45.6 days.

Go to the book's companion website, **www.wiley.com/college/weygandt**, for Additional Self-Study Questions.

✓ The Navigator

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 and notes receivable?

3. Texaco Oil Company issues its own credit cards. Assume that Texaco charges you $40 on an unpaid balance. Prepare the journal entry that Texaco makes to record this revenue.

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

5. Jerry Gatewood cannot understand why cash realizable value does not decrease when an uncollectible account is written off under the allowance method. Clarify this point for Jerry Gatewood.

6. Distinguish between the two bases that may be used in estimating uncollectible accounts.

7. Eaton Company has a credit balance of $3,500 in Allowance for Doubtful Accounts. The estimated bad debts expense under the percentage-of-sales basis is $4,100. The total estimated uncollectibles under the percentage-of-receivables basis is $5,800. Prepare the adjusting entry under each basis.

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

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

10. An article recently appeared in the *Wall Street Journal* indicating that companies are selling their receivables at a record rate. Why are companies selling their receivables?

11. Pinkston Textiles decides to sell $600,000 of its accounts receivable to First Factors Inc. First Factors assesses a service charge of 3% of the amount of receivables sold. Prepare the journal entry that Pinkston Textiles makes to record this sale.

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

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

14. Indicate the maturity date of each of the following promissory notes:

Date of Note	Terms
(a) March 13	one year after date of note
(b) May 4	3 months after date
(c) June 20	30 days after date
(d) July 1	60 days after date

15. Compute the missing amounts for each of the following notes.

	Principal	Annual Interest Rate	Time	Total Interest
(a)	?	9%	120 days	$ 600
(b)	$30,000	10%	3 years	?
(c)	$60,000	?	5 months	$2,000
(d)	$45,000	8%	?	$1,200

16. In determining interest revenue, some financial institutions use 365 days per year and others use 360 days. Why might a financial institution use 360 days?

17. Cain Company dishonors a note at maturity. What are the options available to the lender?

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

19. The accounts receivable turnover ratio is 8.14, and average net receivables during the period are $400,000. What is the amount of net credit sales for the period?

20. PEPSICO What percentage does PepsiCo's allowance for doubtful accounts represent as a percent of its gross receivables in 2008?

BRIEF EXERCISES

WILEY PLUS

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.
(SO 1)

(a) Sold merchandise on account for $64,000 to a customer.
(b) Received a promissory note of $57,000 for services performed.
(c) Advanced $10,000 to an employee.

BE8-2 Record the following transactions on the books of Keyser Co.

Record basic accounts receivable transactions.
(SO 2)

(a) On July 1, Keyser Co. sold merchandise on account to Maxfield Inc. for $15,200, terms 2/10, n/30.
(b) On July 8, Maxfield Inc. returned merchandise worth $3,800 to Keyser Co.
(c) On July 11, Maxfield Inc. paid for the merchandise.

BE8-3 During its first year of operations, Henley Company had credit sales of $3,000,000; $600,000 remained uncollected at year-end. The credit manager estimates that $35,000 of these receivables will become uncollectible.

Prepare entry for allowance method and partial balance sheet.
(SO 3, 9)

(a) Prepare the journal entry to record the estimated uncollectibles.
(b) Prepare the current assets section of the balance sheet for Henley Company. Assume that in addition to the receivables it has cash of $90,000, merchandise inventory of $130,000, and prepaid expenses of $7,500.

BE8-4 At the end of 2011, Delong Co. has accounts receivable of $700,000 and an allowance for doubtful accounts of $54,000. On January 24, 2012, the company learns that its receivable from Ristau Inc. is not collectible, and management authorizes a write-off of $5,400.

Prepare entry for write-off; determine cash realizable value.
(SO 3)

(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?

Prepare entries for collection of bad debts write-off. (SO 3)

BE8-5 Assume the same information as BE8-4. On March 4, 2012, Delong Co. receives payment of $5,400 in full from Ristau Inc. Prepare the journal entries to record this transaction.

Prepare entry using percentage-of-sales method. (SO 3)

BE8-6 Nieto Co. elects to use the percentage-of-sales basis in 2011 to record bad debts expense. It estimates that 2% of net credit sales will become uncollectible. Sales are $800,000 for 2011, sales returns and allowances are $45,000, and the allowance for doubtful accounts has a credit balance of $9,000. Prepare the adjusting entry to record bad debts expense in 2011.

Prepare entry using percentage-of-receivables method. (SO 3)

BE8-7 Linhart Co. uses the percentage-of-receivables basis to record bad debts expense. It estimates that 1% of accounts receivable will become uncollectible. Accounts receivable are $450,000 at the end of the year, and the allowance for doubtful accounts has a credit balance of $1,500.

(a) Prepare the adjusting journal entry to record bad debts expense for the year.
(b) If the allowance for doubtful accounts had a debit balance of $800 instead of a credit balance of $1,500, determine the amount to be reported for bad debts expense.

Prepare entries to dispose of accounts receivable. (SO 4)

BE8-8 Presented below are two independent transactions.

(a) St. Pierre Restaurant accepted a Visa card in payment of a $150 lunch bill. The bank charges a 4% fee. What entry should St. Pierre make?
(b) Jamar Company sold its accounts receivable of $60,000. What entry should Jamar make, given a service charge of 3% on the amount of receivables sold?

Compute interest and determine maturity dates on notes. (SO 5)

BE8-9 Compute interest and find the maturity date for the following notes.

	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

Determine maturity dates and compute interest and rates on notes. (SO 5)

BE8-10 Presented below are data on three promissory notes. Determine the missing amounts.

	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%	?

Prepare entry for notes receivable exchanged for account receivable. (SO 6)

BE8-11 On January 10, 2011, Edmunds Co. sold merchandise on account to Jeff Gallup for $13,600, n/30. On February 9, Jeff Gallup gave Edmunds Co. a 10% promissory note in settlement of this account. Prepare the journal entry to record the sale and the settlement of the account receivable.

Compute ratios to analyze receivables. (SO 9)

BE8-12 The financial statements of Minnesota Mining and Manufacturing Company (3M) report net sales of $20.0 billion. Accounts receivable (net) are $2.7 billion at the beginning of the year and $2.8 billion at the end of the year. Compute 3M's receivables turnover ratio. Compute 3M's average collection period for accounts receivable in days.

Do it! Review

Prepare entry for uncollectible accounts. (SO 3)

Do it! 8-1 Etienne Company has been in business several years. At the end of the current year, the ledger shows:

Accounts Receivable	$ 310,000	Dr.
Sales	2,200,000	Cr.
Allowance for Doubtful Accounts	6,100	Cr.

Bad debts are estimated to be 7% of receivables. Prepare the entry to adjust the Allowance for Doubtful Accounts.

Prepare entry for factored accounts. (SO 4)

Do it! 8-2 Ronald Distributors is a growing company whose ability to raise capital has not been growing as quickly as its expanding assets and sales. Ronald's local banker has indicated that the company cannot increase its borrowing for the foreseeable future. Ronald's suppliers are demanding payment for goods acquired within 30 days of the invoice date, but Ronald's customers are slow in paying for their purchases (60–90 days). As a result, Ronald has a cash flow problem.

Ronald needs $960,000 to cover next Friday's payroll. Its balance of outstanding accounts receivable totals $1,000,000. What might Ronald do to alleviate this cash crunch? Record the entry that Ronald would make when it raises the needed cash. (Assume a 2% service charge.)

Do it! 8-3 Galen Wholesalers accepts from Picard Stores a $6,200, 4-month, 12% note dated May 31 in settlement of Picard's overdue account. (a) What is the maturity date of the note? (b) What is the entry made by Galen at the maturity date, assuming Picard pays the note and interest in full at that time?

Prepare entries for notes receivable.

(SO 5, 8)

Do it! 8-4 In 2011, Drew Gooden Company has net credit sales of $1,600,000 for the year. It had a beginning accounts receivable (net) balance of $101,000 and an ending accounts receivable (net) balance of $107,000. Compute Drew Gooden Company's (a) accounts receivable turnover and (b) average collection period in days.

Compute ratios for receivables.

(SO 9)

EXERCISES

E8-1 Presented below are selected transactions of Pale Force Company. Pale Force sells in large quantities to other companies and also sells its product in a small retail outlet.

Journalize entries related to accounts receivable.

(SO 2)

March	1	Sold merchandise on account to CC Company for $3,000, terms 2/10, n/30.
	3	CC Company returned merchandise worth $500 to Pale Force.
	9	Pale Force collected the amount due from CC Company from the March 1 sale.
	15	Pale Force sold merchandise for $400 in its retail outlet. The customer used his Pale Force credit card.
	31	Pale Force added 1.5% monthly interest to the customer's credit card balance.

Instructions

Prepare journal entries for the transactions above.

E8-2 Presented below are two independent situations.

Journalize entries for recognizing accounts receivable.

(SO 2)

(a) On January 6, Arneson Co. sells merchandise on account to Cortez Inc. for $9,000, terms 2/10, n/30. On January 16, Cortez Inc. pays the amount due. Prepare the entries on Arneson's books to record the sale and related collection.

(b) On January 10, Mary Dawes uses her Pierson Co. credit card to purchase merchandise from Pierson Co. for $9,000. On February 10, Dawes is billed for the amount due of $9,000. On February 12, Dawes pays $5,000 on the balance due. On March 10, Dawes is billed for the amount due, including interest at 2% per month on the unpaid balance as of February 12. Prepare the entries on Pierson Co.'s books related to the transactions that occurred on January 10, February 12, and March 10.

E8-3 The ledger of Hixson Company at the end of the current year shows Accounts Receivable $120,000, Sales $840,000, and Sales Returns and Allowances $30,000.

Journalize entries to record allowance for doubtful accounts using two different bases.

(SO 3)

Instructions

(a) If Hixson uses the direct write-off method to account for uncollectible accounts, journalize the adjusting entry at December 31, assuming Hixson determines that Fell's $1,400 balance is uncollectible.

(b) If Allowance for Doubtful Accounts has a credit balance of $2,100 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be (1) 1% of net sales, and (2) 10% of accounts receivable.

(c) If Allowance for Doubtful Accounts has a debit balance of $200 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be (1) 0.75% of net sales and (2) 6% of accounts receivable.

E8-4 Ingles Company has accounts receivable of $93,100 at March 31. An analysis of the accounts shows the information on the next page.

Determine bad debts expense; prepare the adjusting entry for bad debts expense.
(SO 3)

Month of Sale	Balance, March 31
March	$60,000
February	17,600
January	8,500
Prior to January	7,000
	$93,100

Credit terms are 2/10, n/30. At March 31, Allowance for Doubtful Accounts has a credit balance of $1,200 prior to adjustment. The company uses the percentage-of-receivables basis for estimating uncollectible accounts. The company's estimate of bad debts is as follows.

Age of Accounts	Estimated Percentage Uncollectible
1–30 days	2.0%
31–60 days	5.0%
61–90 days	30.0%
Over 90 days	50.0%

Instructions

(a) Determine the total estimated uncollectibles.
(b) Prepare the adjusting entry at March 31 to record bad debts expense.

Journalize write-off and recovery.
(SO 3)

E8-5 At December 31, 2010, Braddock Company had a balance of $15,000 in the Allowance for Doubtful Accounts. During 2011, Braddock wrote off accounts totaling $13,000. One of those accounts ($1,800) was later collected. At December 31, 2011, an aging schedule indicated that the balance in the Allowance for Doubtful Accounts should be $19,000.

Instructions

Prepare journal entries to record the 2011 transactions of Braddock Company.

Journalize percentage-of-sales basis, write-off, recovery.
(SO 3)

E8-6 On December 31, 2011, Jarnigan Co. estimated that 2% of its net sales of $400,000 will become uncollectible. The company recorded this amount as an addition to Allowance for Doubtful Accounts. On May 11, 2012, Jarnigan Co. determined that Terry Frye's account was uncollectible and wrote off $1,100. On June 12, 2012, Frye paid the amount previously written off.

Instructions

Prepare the journal entries on December 31, 2011, May 11, 2012 and June 12, 2012.

Journalize entries for the sale of accounts receivable.
(SO 4)

E8-7 Presented below are two independent situations.

(a) On March 3, Cornwell Appliances sells $680,000 of its receivables to Marsh Factors Inc. Marsh Factors assesses a finance charge of 3% of the amount of receivables sold. Prepare the entry on Cornwell Appliances' books to record the sale of the receivables.
(b) On May 10, Dale Company sold merchandise for $3,500 and accepted the customer's America Bank MasterCard. America Bank charges a 4% service charge for credit card sales. Prepare the entry on Dale Company's books to record the sale of merchandise.

Journalize entries for credit card sales.
(SO 4)

E8-8 Presented below are two independent situations.

(a) On April 2, Nancy Hansel uses her J. C. Penney Company credit card to purchase merchandise from a J. C. Penney store for $1,500. On May 1, Hansel is billed for the $1,500 amount due. Hansel pays $700 on the balance due on May 3. On June 1, Hansel receives a bill for the amount due, including interest at 1.0% per month on the unpaid balance as of May 3. Prepare the entries on J. C. Penney Co.'s books related to the transactions that occurred on April 2, May 3, and June 1.
(b) On July 4, Kimble's Restaurant accepts a Visa card for a $200 dinner bill. Visa charges a 3% service fee. Prepare the entry on Kimble's books related to this transaction.

Journalize credit card sales, and indicate the statement presentation of financing charges and service charge expense.
(SO 4)

E8-9 Topeka Stores accepts both its own and national credit cards. During the year the following selected summary transactions occurred.

Jan. 15 Made Topeka credit card sales totaling $18,000. (There were no balances prior to January 15.)
20 Made Visa credit card sales (service charge fee 2%) totaling $4,300.
Feb. 10 Collected $10,000 on Topeka credit card sales.
15 Added finance charges of 1% to Topeka credit card balance.

Instructions

(a) Journalize the transactions for Topeka Stores.
(b) Indicate the statement presentation of the financing charges and the credit card service charge expense for Topeka Stores.

Journalize entries for notes receivable transactions.
(SO 5, 6)

E8-10 Orosco Supply Co. has the following transactions related to notes receivable during the last 2 months of 2011.

Nov. 1 Loaned $15,000 cash to Sally Givens on a 1-year, 10% note.
Dec. 11 Sold goods to John Countryman, Inc., receiving a $6,750, 90-day, 8% note.
16 Received a $4,000, 6-month, 9% note in exchange for Bob Reber's outstanding accounts receivable.
31 Accrued interest revenue on all notes receivable.

Instructions

(a) Journalize the transactions for Orosco Supply Co.
(b) Record the collection of the Givens note at its maturity in 2012.

Journalize entries for notes receivable.
(SO 5, 6)

E8-11 Record the following transactions for Sandwich Co. in the general journal.

2011

May 1 Received a $7,500, 1-year, 10% note in exchange for Julia Gonzalez's outstanding accounts receivable.
Dec. 31 Accrued interest on the Gonzalez note.
Dec. 31 Closed the interest revenue account.

2012

May 1 Received principal plus interest on the Gonzalez note. (No interest has been accrued in 2012.)

Prepare entries for note receivable transactions.
(SO 5, 6, 8)

E8-12 Singletary Company had the following select transactions.

Apr. 1, 2011 Accepted Wilson Company's 1-year, 12% note in settlement of a $20,000 account receivable.
July 1, 2011 Loaned $25,000 cash to Richard Dent on a 9-month, 10% note.
Dec. 31, 2011 Accrued interest on all notes receivable.
Apr. 1, 2012 Received principal plus interest on the Wilson note.
Apr. 1, 2012 Richard Dent dishonored its note; Singletary expects it will eventually collect.

Instructions

Prepare journal entries to record the transactions. Singletary prepares adjusting entries once a year on December 31.

Journalize entries for dishonor of notes receivable.
(SO 5, 8)

E8-13 On May 2, Kleinsorge Company lends $7,600 to Everhart, Inc., issuing a 6-month, 9% note. At the maturity date, November 2, Everhart indicates that it cannot pay.

Instructions

(a) Prepare the entry to record the issuance of the note.
(b) Prepare the entry to record the dishonor of the note, assuming that Kleinsorge Company expects collection will occur.
(c) Prepare the entry to record the dishonor of the note, assuming that Kleinsorge Company does not expect collection in the future.

Compute receivables turnover and average collection period.
(SO 9)

E8-14 Bledel Company had accounts receivable of $100,000 on January 1, 2011. The only transactions that affected accounts receivable during 2011 were net credit sales of $1,000,000, cash collections of $900,000, and accounts written off of $30,000.

Instructions

(a) Compute the ending balance of accounts receivable.
(b) Compute the accounts receivable turnover ratio for 2011.
(c) Compute the average collection period in days.

EXERCISES: SET B AND CHALLENGE EXERCISES

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

PROBLEMS: SET A

Prepare journal entries related to bad debts expense.

(SO 2, 3, 9)

P8-1A At December 31, 2010, Leis Co. reported the following information on its balance sheet.

Accounts receivable	$960,000
Less: Allowance for doubtful accounts	80,000

During 2011, the company had the following transactions related to receivables.

1. Sales on account	$3,200,000
2. Sales returns and allowances	50,000
3. Collections of accounts receivable	2,810,000
4. Write-offs of accounts receivable deemed uncollectible	90,000
5. Recovery of bad debts previously written off as uncollectible	24,000

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.

(b) Enter the January 1, 2011, balances in Accounts Receivable and Allowance for Doubtful Accounts, post the entries to the two accounts (use T accounts), and determine the balances.

(c) Prepare the journal entry to record bad debts expense for 2011, assuming that an aging of accounts receivable indicates that expected bad debts are $115,000.

(d) Compute the accounts receivable turnover ratio for 2011.

(b) Accounts receivable $1,210,000
ADA $14,000
(c) Bad debts expense $101,000

Compute bad debts amounts.

(SO 3)

GLS

P8-2A Information related to Hermesch Company for 2011 is summarized below.

Total credit sales	$2,200,000
Accounts receivable at December 31	825,000
Bad debts written off	33,000

Instructions

(a) What amount of bad debts expense will Hermesch Company report if it uses the direct write-off method of accounting for bad debts?

(b) Assume that Hermesch Company estimates its bad debts expense to be 2% of credit sales. What amount of bad debts expense will Hermesch record if it has an Allowance for Doubtful Accounts credit balance of $4,000?

(c) Assume that Hermesch Company estimates its bad debts expense based on 6% of accounts receivable. What amount of bad debts expense will Hermesch record if it has an Allowance for Doubtful Accounts credit balance of $3,000?

(d) Assume the same facts as in (c), except that there is a $3,000 debit balance in Allowance for Doubtful Accounts. What amount of bad debts expense will Hermesch record?

(e) What is the weakness of the direct write-off method of reporting bad debts expense?

Journalize entries to record transactions related to bad debts.

(SO 2, 3)

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

Worksheet.xls

File Edit View Insert Format Tools Data Window Help

	A	B	C	D	E	F	G
1				Number of Days Past Due			
2			Not				
3	Customer	Total	Yet Due	1–30	31–60	61–90	Over 90
4	Arndt	$ 22,000		$10,000	$12,000		
5	Blair	40,000	$ 40,000				
6	Chase	57,000	16,000	6,000		$35,000	
7	Drea	34,000					$34,000
8	Others	132,000	96,000	16,000	14,000		6,000
9		$285,000	$152,000	$32,000	$26,000	$35,000	$40,000
10	Estimated Percentage Uncollectible		3%	6%	13%	25%	60%
11	Total Estimated Bad Debts	$ 42,610	$ 4,560	$ 1,920	$ 3,380	$ 8,750	$24,000
12							

At December 31, 2011, the unadjusted balance in Allowance for Doubtful Accounts is a credit of $12,000.

Instructions

(a) Journalize and post the adjusting entry for bad debts at December 31, 2011.

(b) Journalize and post to the allowance account the following events and transactions in the year 2012.

  (1) On March 31, a $1,000 customer balance originating in 2011 is judged uncollectible.

  (2) On May 31, a check for $1,000 is received from the customer whose account was written off as uncollectible on March 31.

(c) Journalize the adjusting entry for bad debts on December 31, 2012, assuming that the unadjusted balance in Allowance for Doubtful Accounts is a debit of $800 and the aging schedule indicates that total estimated bad debts will be $28,600.

(a) Bad debts expense $30,610

(c) Bad debts expense $29,400

P8-4A Wall Inc. uses the allowance method to estimate uncollectible accounts receivable. The company produced the following aging of the accounts receivable at year-end.

Journalize transactions related to bad debts.

(SO 2, 3)

Worksheet.xls

File Edit View Insert Format Tools Data Window Help

	A	B	C	D	E	F	G
1			Number of Days Outstanding				
2							
3		Total	0–30	31–60	61–90	91–120	Over 120
4	Accounts receivable	375,000	220,000	90,000	40,000	10,000	$15,000
5	% uncollectible		1%	4%	6%	8%	10%
6	Estimated bad debts						
7							

Instructions

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

(b) Prepare the year-end adjusting journal entry to record the bad debts using the aged uncollectible accounts receivable determined in (a). Assume the current balance in Allowance for Doubtful Accounts is a $8,000 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 Wall Inc. 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?

(a) Tot. est. bad debts $10,500

P8-5A At December 31, 2011, the trial balance of Worcester Company contained the following amounts before adjustment.

Journalize entries to record transactions related to bad debts.

(SO 3)

	Debits	Credits
Accounts Receivable	$385,000	
Allowance for Doubtful Accounts		$ 2,000
Sales		950,000

Instructions

(a) Based on the information given, which method of accounting for bad debts is Worcester Company using—the direct write-off method or the allowance method? How can you tell?

(b) Prepare the adjusting entry at December 31, 2011, for bad debts expense under each of the following independent assumptions.

  (1) An aging schedule indicates that $11,750 of accounts receivable will be uncollectible.

  (2) The company estimates that 1% of sales will be uncollectible.

(b) (2) $9,500

(c) Repeat part (b) assuming that instead of a credit balance there is an $2,000 debit balance in Allowance for Doubtful Accounts.

(d) During the next month, January 2012, a $3,000 account receivable is written off as uncollectible. Prepare the journal entry to record the write-off.

(e) Repeat part (d) assuming that Worcester uses the direct write-off method instead of the allowance method in accounting for uncollectible accounts receivable.

(f) What type of account is Allowance for Doubtful Accounts? How does it affect how accounts receivable is reported on the balance sheet at the end of the accounting period?

Prepare entries for various notes receivable transactions.

(SO 2, 4, 5, 8, 9)

P8-6A Mendosa Company closes its books monthly. On September 30, selected ledger account balances are:

Notes Receivable	$33,000
Interest Receivable	170

Notes Receivable include the following.

Date	Maker	Face	Term	Interest
Aug. 16	Chang Inc.	$ 8,000	60 days	8%
Aug. 25	Hughey Co.	9,000	60 days	10%
Sept. 30	Skinner Corp.	16,000	6 months	9%

Interest is computed using a 360-day year. During October, the following transactions were completed.

Oct. 7 Made sales of $6,900 on Mendosa credit cards.
12 Made sales of $900 on MasterCard credit cards. The credit card service charge is 3%.
15 Added $460 to Mendosa customer balance for finance charges on unpaid balances.
15 Received payment in full from Chang Inc. on the amount due.
24 Received notice that the Hughey note has been dishonored. (Assume that Hughey is expected to pay in the future.)

Instructions

(a) Journalize the October transactions and the October 31 adjusting entry for accrued interest receivable.

(b) Accounts receivable $16,510

(b) Enter the balances at October 1 in the receivable accounts. Post the entries to all of the receivable accounts.

(c) Total receivables $32,630

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

Prepare entries for various receivable transactions.

(SO 2, 4, 5, 6, 7, 8)

P8-7A On January 1, 2011, Kloppenberg Company had Accounts Receivable $139,000, Notes Receivable $25,000, and Allowance for Doubtful Accounts $13,200. The note receivable is from Sara Rogers Company. It is a 4-month, 12% note dated December 31, 2010. Kloppenberg Company prepares financial statements annually. During the year the following selected transactions occurred.

Jan. 5 Sold $20,000 of merchandise to Dedonder Company, terms n/15.
20 Accepted Dedonder Company's $20,000, 3-month, 9% note for balance due.
Feb. 18 Sold $8,000 of merchandise to Ludwig Company and accepted Ludwig's $8,000, 6-month, 9% note for the amount due.
Apr. 20 Collected Dedonder Company note in full.
30 Received payment in full from Sara Rogers Company on the amount due.
May 25 Accepted Jenks Inc.'s $4,000, 3-month, 7% note in settlement of a past-due balance on account.
Aug. 18 Received payment in full from Ludwig Company on note due.
25 The Jenks Inc. note was dishonored. Jenks Inc. is not bankrupt; future payment is anticipated.
Sept. 1 Sold $12,000 of merchandise to Lena Torme Company and accepted a $12,000, 6-month, 10% note for the amount due.

Instructions

Journalize the transactions.

PROBLEMS: SET B

Prepare journal entries related to bad debts expense.

(SO 2, 3, 9)

P8-1B At December 31, 2010, Dill Imports reported the following information on its balance sheet.

Accounts receivable	$250,000
Less: Allowance for doubtful accounts	15,000

During 2011, the company had the following transactions related to receivables.

1.	Sales on account	$2,400,000
2.	Sales returns and allowances	45,000
3.	Collections of accounts receivable	2,250,000
4.	Write-offs of accounts receivable deemed uncollectible	12,000
5.	Recovery of bad debts previously written off as uncollectible	3,000

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.

(b) Enter the January 1, 2011, balances in Accounts Receivable and Allowance for Doubtful Accounts. Post the entries to the two accounts (use T accounts), and determine the balances.

(c) Prepare the journal entry to record bad debts expense for 2011, assuming that an aging of accounts receivable indicates that estimated bad debts are $22,000.

(d) Compute the accounts receivable turnover ratio for the year 2011.

(b) Accounts receivable $343,000
ADA $6,000
(c) Bad debts expense $16,000

P8-2B Information related to Bee Company for 2011 is summarized below.

Compute bad debts amounts.
(SO 3)

Total credit sales	$1,100,000
Accounts receivable at December 31	369,000
Bad debts written off	22,150

Instructions

(a) What amount of bad debts expense will Bee Company report if it uses the direct write-off method of accounting for bad debts?

(b) Assume that Bee Company decides to estimate its bad debts expense to be 2% of credit sales. What amount of bad debts expense will Bee record if Allowance for Doubtful Accounts has a credit balance of $3,000?

(c) Assume that Bee Company decides to estimate its bad debts expense based on 6% of accounts receivable. What amount of bad debts expense will Bee Company record if Allowance for Doubtful Accounts has a credit balance of $4,000?

(d) Assume the same facts as in (c), except that there is a $2,000 debit balance in Allowance for Doubtful Accounts. What amount of bad debts expense will Bee record?

(e) What is the weakness of the direct write-off method of reporting bad debts expense?

P8-3B Presented below is an aging schedule for Jafar Company.

Journalize entries to record transactions related to bad debts.
(SO 2, 3)

Worksheet.xls

File Edit View Insert Format Tools Data Window Help

	A	B	C	D	E	F	G
1				Number of Days Past Due			
2			Not				
3	Customer	Total	Yet Due	1–30	31–60	61–90	Over 90
4	Akers	$ 30,000		$13,500	$16,500		
5	Baietto	45,000	$ 45,000				
6	Comer	75,000	22,500	7,500		$45,000	
7	DeJong	57,000					$57,000
8	Others	189,000	138,000	22,500	19,500		9,000
9		$396,000	$205,500	$43,500	$36,000	$45,000	$66,000
10	Estimated Percentage Uncollectible		2%	6%	10%	25%	50%
11	Total Estimated Bad Debts	$ 54,570	$ 4,110	$ 2,610	$ 3,600	$11,250	$33,000
12							

At December 31, 2011, the unadjusted balance in Allowance for Doubtful Accounts is a credit of $16,000.

Instructions

(a) Journalize and post the adjusting entry for bad debts at December 31, 2011.

(a) Bad debts expense $38,570

(b) Journalize and post to the allowance account the following events and transactions in the year 2012.

(1) March 1, a $1,900 customer balance originating in 2011 is judged uncollectible.

(2) May 1, a check for $1,900 is received from the customer whose account was written off as uncollectible on March 1.

(c) Journalize the adjusting entry for bad debts on December 31, 2012. Assume that the unadjusted balance in Allowance for Doubtful Accounts is a debit of $2,000, and the aging schedule indicates that total estimated bad debts will be $42,300.

(c) Bad debts expense $44,300

Journalize transactions related to bad debts.
(SO 2, 3)

P8-4B The following represents selected information taken from a company's aging schedule to estimate uncollectible accounts receivable at year end.

Worksheet.xls

File Edit View Insert Format Tools Data Window Help

	A	B	C	D	E	F	G
1			Number of Days Outstanding				
2							
3		Total	0–30	31–60	61–90	91–120	Over 120
4	Accounts receivable	$375,000	$220,000	$90,000	$40,000	$10,000	$15,000
5	% uncollectible		1%	4%	5%	8%	10%
6	Estimated bad debts						
7							

(a) Tot. est. bad debts $10,100

Instructions

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

(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 current balance in the Allowance for Doubtful Accounts account is a $3,000 credit.

(c) Of the above accounts, $1,600 is determined to be specifically uncollectible. Prepare the journal entry to write off the uncollectible accounts.

(d) The company subsequently collects $700 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.

Journalize entries to record transactions related to bad debts.
(SO 3)

P8-5B At December 31, 2011, the trial balance of Liquid Snake Company contained the following amounts before adjustment.

	Debits	Credits
Accounts Receivable	$250,000	
Allowance for Doubtful Accounts		$ 1,100
Sales		600,000

(a) (2) $12,000

Instructions

(a) Prepare the adjusting entry at December 31, 2011, to record bad debts expense under each of the following independent assumptions.
  (1) An aging schedule indicates that $12,500 of accounts receivable will be uncollectible.
  (2) The company estimates that 2% of sales will be uncollectible.

(b) Repeat part (a) assuming that instead of a credit balance, there is a $1,100 debit balance in Allowance for Doubtful Accounts.

(c) During the next month, January 2012, a $3,200 account receivable is written off as uncollectible. Prepare the journal entry to record the write-off.

(d) Repeat part (c) assuming that Liquid Snake 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?

Prepare entries for various notes receivable transactions.
(SO 2, 4, 5, 8, 9)

GLS

P8-6B Marty Co. closes its books monthly. On June 30, selected ledger account balances are:

Notes Receivable	$57,000
Interest Receivable	420

Notes Receivable include the following.

Date	Maker	Face	Term	Interest
May 16	Rice Inc.	$12,000	60 days	10%
May 25	Smelter Co.	30,000	60 days	9%
June 30	Kupp Corp.	15,000	6 months	12%

During July, the following transactions were completed.

July 5 Made sales of $7,200 on Marty Co. credit cards.
14 Made sales of $1,000 on Visa credit cards. The credit card service charge is 3%.
14 Added $510 to Marty Co. credit card customer balances for finance charges on unpaid balances.
15 Received payment in full from Rice Inc. on the amount due.
25 Received notice that the Smelter Co. note has been dishonored. (Assume that Smelter Co. is expected to pay in the future.)

Instructions

(a) Journalize the July transactions and the July 31 adjusting entry for accrued interest receivable. (Interest is computed using 360 days.)

(b) Enter the balances at July 1 in the receivable accounts. Post the entries to all of the receivable accounts.

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

(b) Accounts receivable $38,160

(c) Total receivables $53,310

Prepare entries for various receivable transactions.

(SO 2, 4, 5, 6, 7, 8)

P8-7B On January 1, 2011, Furball Company had Accounts Receivable $98,000 and Allowance for Doubtful Accounts $8,100. Furball Company prepares financial statements annually. During the year the following selected transactions occurred.

Jan. 5 Sold $10,800 of merchandise to Kandle Company, terms n/30.
Feb. 2 Accepted a $10,800, 4-month, 10% promissory note from Kandle Company for the balance due.
12 Sold $13,500 of merchandise to Lowe Company and accepted Lowe's $13,500, 2-month, 10% note for the balance due.
26 Sold $7,000 of merchandise to Barrel Co., terms n/10.
Apr. 5 Accepted a $7,000, 3-month, 8% note from Barrel Co. for the balance due.
12 Collected Lowe Company note in full.
June 2 Collected Kandle Company note in full.
July 5 Barrel Co. dishonors its note of April 5. It is expected that Barrel will eventually pay the amount owed.
15 Sold $12,000 of merchandise to Bushel Co. and accepted Bushel's $12,000, 3-month, 12% note for the amount due.
Oct. 15 Bushel Co.'s note was dishonored. Bushel Co. is bankrupt, and there is no hope of future settlement.

Instructions

Journalize the transactions.

PROBLEMS: SET C

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

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,
www.wiley.com/college/weygandt,
to see the completion of this problem.

BROADENING YOUR PERSPECTIVE

FINANCIAL REPORTING AND ANALYSIS

Financial Reporting Problem: SEK Company

BYP8-1 SEK Company sells office equipment and supplies to many organizations in the city and surrounding area on contract terms of 2/10, n/30. In the past, over 75% of the credit customers have taken advantage of the discount by paying within 10 days of the invoice date.

The number of customers taking the full 30 days to pay has increased within the last year. Current indications are that less than 60% of the customers are now taking the discount. Bad debts as a percentage of gross credit sales have risen from the 2.5% provided in past years to about 4.5% in the current year.

The company's Finance Committee has requested more information on the collections of accounts receivable. The controller responded to this request with the report reproduced below.

SEK COMPANY
Accounts Receivable Collections
May 31, 2011

The fact that some credit accounts will prove uncollectible is normal. Annual bad debts write-offs have been 2.5% of gross credit sales over the past 5 years. During the last fiscal year, this percentage increased to slightly less than 4.5%. The current Accounts Receivable balance is $1,400,000. The condition of this balance in terms of age and probability of collection is as follows.

Proportion of Total	Age Categories	Probability of Collection
62%	not yet due	98%
20%	less than 30 days past due	96%
9%	30 to 60 days past due	94%
5%	61 to 120 days past due	91%
$2\frac{1}{2}$%	121 to 180 days past due	75%
$1\frac{1}{2}$%	over 180 days past due	30%

The Allowance for Doubtful Accounts had a credit balance of $29,500 on June 1, 2010. SEK has provided for a monthly bad debts expense accrual during the current fiscal year based on the assumption that 4.5% of gross credit sales will be uncollectible. Total gross credit sales for the 2010–11 fiscal year amounted to $2,900,000. Write-offs of bad accounts during the year totaled $102,000.

Instructions

(a) Prepare an accounts receivable aging schedule for SEK Company using the age categories identified in the controller's report to the Finance Committee showing the following.
  (1) The amount of accounts receivable outstanding for each age category and in total.
  (2) The estimated amount that is uncollectible for each category and in total.

(b) Compute the amount of the year-end adjustment necessary to bring Allowance for Doubtful Accounts to the balance indicated by the age analysis. Then prepare the necessary journal entry to adjust the accounting records.

(c) In a recessionary environment with tight credit and high interest rates:
  (1) Identify steps SEK Company might consider to improve the accounts receivable situation.
  (2) Then evaluate each step identified in terms of the risks and costs involved.

Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company

BYP8-2 PepsiCo, Inc.'s financial statements are presented in Appendix A. Financial statements of The Coca-Cola Company are presented in Appendix B.

Instructions

(a) Based on the information in these financial statements, compute the following 2008 ratios for each company. (Assume all sales are credit sales and that PepsiCo's receivables on its balance sheet are all trade receivables.)

(1) Accounts receivable turnover ratio.

(2) Average collection period for receivables.

(b) What conclusions about managing accounts receivable can you draw from these data?

Exploring the Web

BYP8-3 **Purpose:** To learn more about factoring services.

Address: www.invoicebankers.com, or go to **www.wiley.com/college/weygandt**

Steps: Go to the website 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

BYP8-4 Molly and Joe Mayne own Campus Fashions. From its inception Campus Fashions has sold merchandise on either a cash or credit basis, but no credit cards have been accepted. During the past several months, the Maynes have begun to question their sales policies. First, they have lost some sales because of refusing to accept credit cards. Second, representatives of two metropolitan banks have been persuasive in almost convincing them to accept their national credit cards. One bank, City National Bank, has stated that its credit card fee is 4%.

The Maynes decide that they should determine the cost of carrying their own credit sales. From the accounting records of the past 3 years they accumulate the following data.

	2011	2010	2009
Net credit sales	$500,000	$600,000	$400,000
Collection agency fees for slow-paying customers	2,450	2,500	2,400
Salary of part-time accounts receivable clerk	4,100	4,100	4,100

Credit and collection expenses as a percentage of net credit sales are: uncollectible accounts 1.6%, billing and mailing costs 0.5%, and credit investigation fee on new customers 0.15%.

Molly and Joe also determine that the average accounts receivable balance outstanding during the year is 5% of net credit sales. The Maynes estimate that they could earn an average of 8% annually on cash invested in other business opportunities.

Instructions

With the class divided into groups, answer the following.

(a) Prepare a table showing, for each year, total credit and collection expenses in dollars and as a percentage of net credit sales.

(b) Determine the net credit and collection expense in dollars and as a percentage of sales after considering the revenue not earned from other investment opportunities.

(c) Discuss both the financial and nonfinancial factors that are relevant to the decision.

Communication Activity

BYP8-5 Rene Mai, a friend of yours, overheard a discussion at work about changes her employer wants to make in accounting for uncollectible accounts. Rene knows little about accounting, and she asks you to help make sense of what she heard. Specifically, she asks you to explain the differences between the percentage-of-sales, percentage-of-receivables, and the direct write-off methods for uncollectible accounts.

Instructions
In a letter of one page (or less), explain to Rene the three methods of accounting for uncollectibles. Be sure to discuss differences among these methods.

Ethics Case

BYP8-6 The controller of Ruiz Co. believes that the yearly allowance for doubtful accounts for Ruiz Co. should be 2% of net credit sales. The president of Ruiz Co., nervous that the stockholders might expect the company to sustain its 10% growth rate, suggests that the controller increase the allowance for doubtful accounts to 4%. The president thinks that the lower net income, which reflects a 6% growth rate, will be a more sustainable rate for Ruiz Co.

Instructions
(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 Ruiz Co.'s growth rate? Explain your answer.

"All About You" Activity

BYP8-7 As the **All About You** feature in this chapter (page 376) indicates, 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 Brothers 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 Web 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

BYP8-8 Access the FASB Codification at *http://asc.fasb.org* to 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 Debts Expense) should be reported?

Answers to Insight and Accounting Across the Organization Questions

p. 367 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 could do so 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. 367 How Does a Credit Card Work?
Q: Assume that Nordstrom prepares a bank reconciliation at the end of each month. If some credit card sales have not been processed by the bank, how should Nordstrom treat these transactions on its bank reconciliation?
A: *Nordstrom would treat the credit card receipts as deposits in transit. It has already recorded the receipts as cash. Its bank will increase Nordstrom's cash account when it receives the receipts.*

Authors' Comments on *All About You:* Should You Be Carrying Plastic? (p. 376)

We aren't going to tell you to cut up your credit card(s). Well, we aren't going to tell *all* of you to do so. Credit cards, when used properly, can serve a very useful purpose. They provide great convenience, are widely accepted, and can be a source of security in an emergency. But too many Americans use credit cards inappropriately. When businesses purchase short-term items such as inventory and supplies, they use short-term credit, which they expect to pay back very quickly. The same should be true of your credit card. When you make purchases of everyday items, you should completely pay off those items within a month or two. If you don't, you are living beyond your means, and you will soon dig yourself a deep financial pit.

Longer-term items should not be purchased with credit cards, since the interest rate is too high. If you currently have a large balance on your credit card(s), we encourage you to cut up your card(s) until you have paid off your balance(s).

Answers to Self-Study Questions

1. d **2.** c **3.** a **4.** b **5.** d **6.** b **7.** b **8.** d **9.** c **10.** c **11.** a **12.** b **13.** d
14. a **15.** c

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