Notes

Chapter 7

Accounting 351

Spring 2011

California State University, Northridge

Uncollectible Accounts

Direct Write-Off Method

Bad Debt Expense	1,000	
Accounts Receivable		1,000

Matching

Allowance Method

% of accounts receivable or credit sales

- 5-year average
- Aging schedule

Example: Accounts Receivable = $50,000
Estimated % = 1%

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2009		2010	
A/R	50,000	A/R	60,000
Allowance U/A	500	Allowance U/A	600
	49,500		59,400

Net Realizable Value

Write-Off

Allowance U/A	100	
A/R		100

AJE (2009)

B/D Expense	500	
Allowance U/A		500

AJE (2010)

B/D Expense	?	
Allowance U/A		?

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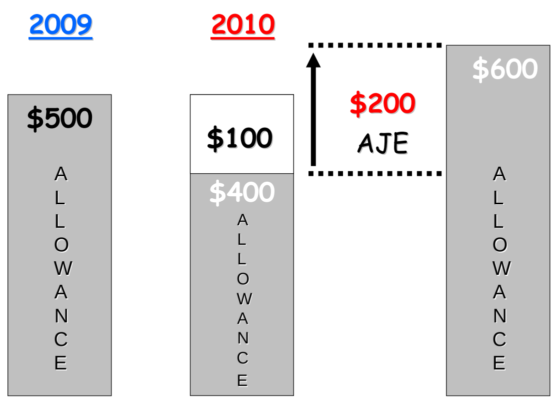

Using the balance sheet approach to estimate bad debt, assume that the ending balance for accounts receivable is **$200,000** and the allowance account before recording the AJE has a **debit** balance of **$6,000**. Using 1%, what is the bad debt expense?

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Bank Reconciliation Statement

Balance per bank statement	X X X	**Balance per books**	X X X
Additions [A]	X X	**Additions [C]**	X X
Deductions [B]	X X	**Deductions [D]**	X X
Adjusted balance	X X X	**Adjusted balance**	X X X

An item that the depositor (Alpha) knew about (and recorded) but the bank did not (at the time the bank statement was prepared) is an adjustment to the balance per bank statement. [A and B]

An item that the bank knew about but the depositor (Alpha) did not (until the bank statement was received and examined by Alpha) is an adjustment to the balance per books. [C and D] Might require AJEs.

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Balance per bank statement	$ Xxxxxx
Add : Deposits in transit	xxxxx
[Receipts recorded on Alpha's books but not yet received by the bank at the time the bank statement was prepared.]	
Error by bank	xxx
[Increases Alpha's bank balance when corrected.]	
Cash on hand	xxx
[Cash kept on premises to make change.]	
Less: Outstanding checks	(xxxxx)
[Checks recorded by Alpha as having been written but have not yet cleared the bank at the time the bank statement was prepared.]	
Error by bank	(xxx)
[Decreases Alpha's bank balance when corrected.]	
Adjusted balance	$ Xxxxxx

Balance per books	$ Xxxxx
Add: Interest earned, notes collected, etc.	xxxx
[Bank balance is increased but not yet recorded on Alpha's books.]	
Error by alpha	xxx
[Increases cash when corrected.]	
Less: NSF check, bank service charge, etc.	(xxx)
[Bank balance is decreased but not yet recorded on Alpha's books.]	
Error by Alpha	(xxx)
[Decreases cash when corrected.]	
Adjusted balance	$ Xxxxxx

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Balance per bank statement	$ Xxxxxx
Add : Deposits in transit	xxxxx
[Receipts recorded on Alpha's books but not yet received by the bank at the time the bank statement was prepared.]	
Error by bank	xxx
[Increases Alpha's bank balance when corrected.]	
Cash on hand	xxx
[Cash kept on premises to make change.]	
Less: Outstanding checks	(xxxxx)
[Checks recorded by Alpha as having been written but have not yet cleared the bank at the time the bank statement was prepared.]	
Error by bank	(xxx)
[Decreases Alpha's bank balance when corrected.]	
Adjusted balance	$ Xxxxxx

You have information the bank doesn't until the bank receives outstanding checks and deposits.

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The bank has information you don't until you receive the bank statement. AJEs?

Balance per books	$ Xxxxx
Add: Interest earned, notes collected, etc.	xxxx
[Bank balance is increased but not yet recorded on Alpha's books.]	
Error by alpha	xxx
[Increases cash when corrected.]	
Less: NSF check, bank service charge, etc.	(xxx)
[Bank balance is decreased but not yet recorded on Alpha's books.]	
Error by Alpha	(xxx)
[Decreases cash when corrected.]	
Adjusted balance	$ Xxxxxx

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Reasons for Factoring ($150 billion annually)

- Unexpected need for cash.
- Use wholly-owned subsidiary collection, credit checks, billing, and financing purchases (credit arm called variable interest entities).
  - Common for sale of durable goods (autos, farm equipment, large equipment, major appliances . . .)
  - Examples: GMAC, John Deere Credit, General Electric Capital Services, Sears, IBM Credit Corp.
- Can't borrow (might have reached debt limit because of debt covenants in existing loans).
- VISA, Mastercard, and American Express are factors.

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Receivable Financing

Factoring/Sale ⇦ Control ⇨ Assignment (Secured Borrowing)

(ASC 860-10-40)

(IAS 39; IFRS 9 – must transfer substantially all the risks and rewards of ownership)

Sale (loss) versus Loan (liability)

Control surrendered if (ASC 860-10-40-5):

(Three Conditions)

- **Transferred assets isolated from transferor**
- **Transferee has right to pledge or sell receivables**
- **Transferor does not maintain control over receivables through (1) repurchase agreement or (2) ability to cause return of the receivables.**

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Bicycle Test (common sense)*

You own a bicycle. How do you know when you've sold your bicycle to someone else?

- **When your bicycle is in someone else's garage, not yours – it is isolated from you.**
- **When someone else has the right to sell your bicycle, run it into the wall, or give it away.**
- **When you can't go back the next day and say "I've changed my mind, sell it back." There is no obligation to sell it back to you.**

1) Someone else has it.

2) They can do anything with it they want.

3) Even if you wanted to buy it back, they don't have to sell it to you.

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*Professor Emeritus Janice Bell, 2004.

Three Conditions Satisfied

Yes → Factoring/Sale

- **With Recourse**
  - Record recourse liability
- **Without Recourse**
  - Remove receivables
  - Record loss

No → Assigning (Secured Borrowing)

- Collections used to pay principal
- Either party may make collections
- "Specific" receivables
- Record interest expense
- Record liability for the loan

No → Pledging

- Used as collateral
- Disclosure note
- Record liability
- Record interest

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Facts: Alpha factored $100,000 of trade receivables to Beta Finance. Alpha received 90%. Beta charges a 5% fee.

1. Without recourse and the three conditions are satisfied.

Differs from pp. 92 & 97

Cash ([90% x $100,000] - $5,000)	85,000	
Loss on Sale of Receivables (5% x $100,000)	5,000	
Receivable from Factor (10% x $100,000)	10,000	
Accounts Receivable		100,000

2. Same facts except assume related allowance for uncollectible accounts is $2,000.

Cash ([90% x $100,000] - $5,000)	85,000	
Loss on Sale of Receivables ([5% x $100,000] - $2,000)	3,000	
Receivable from Factor (10% x $100,000)	10,000	
Allowance for Uncollectible Accounts	**2,000**	
Accounts Receivable		100,000

Same facts: Alpha factored $100,000 of trade receivables to Beta Finance. Alpha received 90%. Beta charges a 5% fee.

3. With recourse (estimated to be $1,000) and the three conditions are satisfied.

Cash ([90% x $100,000] - $5,000)	85,000	
Loss on Sale of Receivables ([5% x $100,000] + $1,000)	6,000	
Receivable from Factor (10% x $100,000)	10,000	
Recourse Liability		**1,000**
Accounts Receivable		100,000

4. Same facts except assume related allowance for uncollectible accounts is $2,000.

Cash ([90% x $100,000] - $5,000)	85,000	
Loss on Sale of Receivables ([5% x $100,000] - $2,000 + $1,000)	4,000	
Receivable from Factor (10% x $100,000)	10,000	
Allowance for Uncollectible Accounts	**2,000**	
Recourse Liability		**1,000**
Accounts Receivable		100,000

5. The three conditions are not satisfied. Alpha assigns $100,000 of specific trade receivables to Beta as collateral for an $80,000 loan. Alpha signs a one-year promissory note at 6% interest. Beta charges a 4% finance fee.

Cash	76,000	
Finance Charge Expense (4% x $100,000)	4,000	
Notes Payable		80,000
Accounts Receivable Assigned	100,000	
Accounts Receivable		100,000
Cash	20,000	
Accounts Receivable Assigned		20,000
Interest Expense (6% x $80,000 x 1/12)	400	
Notes Payable	20,000	
Cash		20,400

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Notes Receivable

Must include an interest component – look at economic substance.

Less than market rate or 0% interest, requires interest to be imputed and a discount account (future unearned interest) to be used.

Imputed interest = prevailing market rate for similar notes, collateral, credit rating, quality, and length.

- Less than 90 days, may ignore interest.
- 90 days to 1 year, may use straight-line interest.
- Over one year, use present value.

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	10%	0%
Face Value of Note (Future Value)	$10,000	$12,100
Sales (Net Present Value)	$10,000	$10,000

n=2,i=10%,T2 $10,000 x .82645 = $8,265
n=2,i=10%,T4 $10,000 x 10% x 1.73554 = 1,735 = $10,000
n=2,i=10%,T2 $12,100 x .82645 = $10,000

	10%	0%
Interest (Compounded 2 Years)	$2,100	$0
($10,000 x 10%) + ($11,000 x 10%) = $2,100		
10% Imputed Interest (Amortize)	$0	$2,100
$12,100 - $10,000 = $2,100		

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Interest-Bearing Notes Receivable

Facts: Alpha received a 10%, 2-year $12,100 note from Beta to complete a sales transaction.

Notes Receivable	12,100	
Sales		12,100

Noninterest-Bearing Notes Receivable

Facts: Alpha received a 2-year $12,100 noninterest-bearing note from Beta to complete a sales transaction. The imputed interest rate was 10%.

Notes Receivable	12,100	
Discount on Notes Receivable		2,100
Sales (n=2, i=10%, T2, $12,100 x .82645)		10,000

Beta

Purchases (Inventory)	10,000	
Discount on Notes Payable	2,100	
Notes Payable		12,100

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Amortizing the Discount

Year 1: $10,000 x 10% = $1,000

Discount on Notes Receivable	1,000	
Interest Revenue		1,000

Balance sheet:

Notes Receivable	12,100
Less: Discount on Notes Receivable	(1,100)
	11,000

Year 2: $11,000 x 10% = $1,100

Discount on Notes Receivable	1,100	
Interest Revenue		1,100

Balance sheet:

Notes Receivable	12,100
Less: Discount on Notes Receivable	(0)
	12,100

Cash	12,100	
Notes Receivable		12,100

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You provided computer services and received a 6-month $6,000 note. Market (imputed) interest rate is 10%.

	Notes Receivable	6,000	
	Discount on NR		300
	Service Revenue		5,700
	(1/2 x 10% x $6,000)		
	Discount on NR	50	
	Interest Revenue		50
If 2-year note:	Notes Receivable	6,000	
	Discount on NR		1,041
	Service Revenue		4,959
	($6,000 x 0.82645)		
Year 1	Discount on NR	496	
	Interest Revenue		496
	(10% x 4,959 = 496)		
Year 2	Discount on NR	545	
	Interest Revenue		545
	(10% x [4,959 + 496] = 545)		

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Facts: Alpha received a 2-year $12,100 note from Beta that pays interest of 2% to complete a sales transaction. The imputed interest rate was 10%.

$12,100 x .82645 = $10,000
$12,100 x 2% = $242 x 1.73554 = 420
$10,420

Notes Receivable	12,100	
Discount on Notes Receivable		1,680
Sales		10,420

Year 1

($10,420 x 10% = $1,042 - $242 = $800)

Cash	242	
Discount on Notes Receivable	800	
Interest Revenue		1,042

Year 2

($10,420 + 800) x 10% = $1,122 - $242 = $880)

Cash	242	
Discount on Notes Receivable	880	
Interest Revenue		1,122

Discounting a Note

Facts: After 60 days, Alpha discounts a $6,000, 10%, 180-day note receivable at the bank at a discount rate of 12%.

(1) Compute the maturity value: $6,000x10%x180/360+$6,000=$6,300

(2) Compute the discount: $6,300x12%x120/360=$252

(3) Compute the proceeds to Alpha: $6,300-$252=$6,048

Cash	6,048		
Interest Revenue		48	
Notes Receivable		6,000	

or

Interest Receivable	100		Year 1 – AJE
Interest Revenue		100	
Cash	6,048		Year 2 – Jan 2
Loss on Sale of Notes Receivable	52		
Interest Receivable		100	
Notes Receivable		6,000	

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