CHAPTER 6
THE CURRENT ASSET CLASSIFICATION, CASH, AND ACCOUNTS RECEIVABLE

BRIEF EXERCISES

BE6–1

a. Total Accounts Receivable = Net Receivables + Allowance for Uncollectibles

2009 Total Accounts Receivable = $3,623 + $93
2009 Total Accounts Receivable = $3,716
2009 Uncollectibles as a Percentage of Total Accounts Receivable = $93/$3,716 = 2.50%

2008 Total Accounts Receivable = $4,618 + $90
2008 Total Accounts Receivable = $4,708
2008 Uncollectibles as a Percentage of Total Accounts Receivable = $90/$4,708 = 1.91%

Therefore, the percentage increased.

b. Since Emerson Electric is using the percentage of accounts receivable method (balance sheet approach), bad debt expense for 2009 would be the amount needed to adjust the allowance for doubtful accounts to $93. This number (bad debt expense) is impacted by the balance in the uncollectible account at the beginning of the year and the write-offs taken during the year by Emerson Electric.

BE6–2

a. 2007:
   Ending Allowance Balance = Beginning Allowance Balance + Bad Debt Charge – Write-Offs + Recoveries
   $4,238 = $3,945 + 4,431 – $5,966 + 1,828
   Bad Debt Expense for 2007 = $4,431

2008:
   Ending Allowance Balance = Beginning Allowance Balance + Bad Debt Charge – Write-Offs + Recoveries
   $5,325 = $4,238 + 7,518 – $8,162 + 1,731
   Bad Debt Expense for 2008 = $7,518

As the economy went into recession in 2008, companies that extend credit (such as GE’s capital division) had a more difficult time collecting receivables.

b. 2007:
   $5,966 write-offs; $4,138 write-offs, net of recoveries
2008:  
$8,162 write-offs; $6,431 write-offs, net of recoveries

c. The allowance account grew by 25.7% (($5,325 - $4,238)/$4,238) from 2007 to 2008. The allowance account grew at such a large rate due to the deterioration of the economy and GE’s belief that a greater amount future receivables will prove to be uncollectible as a result. By increasing the allowance balance the company is taking into consideration that receivables will not be as collectible as when the economy was healthier. Increasing the allowance lowers the “net realizable value” of the receivables on the balance sheet, which is prudent behavior given the economic climate.

E6–4

5/1/12 Accounts Receivable (+A) 30,000  
Sales (R, +SE) 30,000  
*Sold lobster on account.*

5/5/12 Accounts Receivable (+A) 20,000  
Sales (R, +SE) 20,000  
*Sold cod on account.*

5/6/12 Cash (+A) 29,100  
Cash Discount (-R, -SE) 900  
Accounts Receivable (-A) 30,000  
*Collected cash from customer.*

5/31/12 Cash (+A) 20,000  
Accounts Receivable (-A) 20,000  
*Collected cash from customer.*

E6–5

*Allowance for Uncollectibles*

<table>
<thead>
<tr>
<th></th>
<th>2011 Write-Offs</th>
<th>2012 Write-Offs</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/11 Bad Debt Expense</td>
<td>30,000(^1)</td>
<td>28,000(^2)</td>
</tr>
<tr>
<td>Ending Balance</td>
<td>26,000</td>
<td></td>
</tr>
</tbody>
</table>

\(^1\) $1,500,000 \times 0.02 = $30,000  
\(^2\) $1,400,000 \times 0.02 = $28,000

Overall, the bad debts estimates are sufficient to cover the write-offs.
E6–6
a. Ending Allowance Balance = Beginning Allowance Balance + Bad Debt Charge – Write-Offs + Recoveries
$200,000 = Beginning Allowance Balance + $162,500 – $195,000 + $45,000
Beginning Allowance Balance = $187,500

* $162,500 = Sales of $3,250,000 × Estimated uncollectible percentage of 5%

b. [Assume the $4,200,000 cash collections includes the $45,000 recovery]
Ending Accounts Receivable = Beginning Accounts Receivable + Credit Sales during the year – Cash Collected on account receivables during the year – Accounts Receivables written off + Written-Off Accounts Receivables Recovered.

$7,500,000 = X + $3,250,000 – $4,200,000 – $195,000 + $45,000
X = $8,600,000

E6–7
a. Bad Debt Charge (E, –SE) ................................................................. 9
   Allowance for Doubtful Accounts (–A).......................................... 9
   Recognized bad debt charge.

b. Ending Allowance Balance = Beginning Allowance Balance + Bad Debt Charge – Write-Offs + Recoveries
   = $12 + $9 – $11 + $0
   = $10

E6–8
a. Ending Allowance Balance = Beginning Allowance Balance + Bad Debt Charge – Write-Offs + Recoveries
   $1,300 = $1,000 + (Sales of $75,300 × Estimated uncollectible percentage of 2%) – Write-Offs + $55
   Write-Offs = $1,261

b. Accounts Receivable (+A) ............................................................ 75,300
   Sales (R, +SE) ................................................................. 75,300
   Made sales on account.

   Accounts Receivable (+A) ......................................................... 55
   Allowance for Doubtful Accounts (–A) ................................. 55
   Recovered accounts previously written off.

   Allowance for Doubtful Accounts (+A) ........................................ 1,261
   Accounts Receivable (–A) ..................................................... 1,261
   Wrote off accounts deemed uncollectible.
Bad Debt Expense (E, –SE) ................................................................. 1,506
Allowance for Doubtful Accounts (–A) ............................................. 1,506

Recognized bad debt expense.

Cash (+A) ...................................................................................... 73,894*
Accounts Receivable (–A) ................................................................. 73,894

Collected cash from customers.

* $73,894 was calculated as follows:
Ending balance in Accounts Receivable of $9,400 = Beginning balance in Accounts Receivable of $9,200 + 2012 Credit sales of $75,300 – 2012 Cash collections + 2012 Recoveries of $55 – 2012 Write-offs of $1,261

E6–10

Total receivables equals the sum of the receivable balances for each age classification. Therefore, total receivables equals $290,000 + $110,000 + $68,000 + $40,000, or $508,000.

Expected bad debts equals the sum of the estimated uncollectible amounts for each age classification. As shown in the following table, the total expected bad debts associated with the $508,000 currently in accounts receivable is $22,740.

<table>
<thead>
<tr>
<th>Age</th>
<th>Account Balance</th>
<th>Noncollection Probability</th>
<th>Uncollectible Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$290,000</td>
<td>2%</td>
<td>$ 5,800</td>
</tr>
<tr>
<td>1–45 days</td>
<td>110,000</td>
<td>5%</td>
<td>5,500</td>
</tr>
<tr>
<td>46–90 days</td>
<td>68,000</td>
<td>8%</td>
<td>5,440</td>
</tr>
<tr>
<td>&gt;90 days</td>
<td>40,000</td>
<td>15%</td>
<td>6,000</td>
</tr>
<tr>
<td>Total</td>
<td>$508,000</td>
<td></td>
<td>$22,740</td>
</tr>
</tbody>
</table>

P6–2

a. 3/3 Accounts Receivable (+A) ................................................... 1,400
Sales (R, +SE) ................................................................. 1,400
Made sale on account.

3/8 Accounts Receivable (+A) .................................................. 800
Sales (R, +SE) ................................................................. 800
Made sale on account.

3/11 Cash (+A) ............................................................................. 1,372
Cash Discount (–R, –SE) ........................................................... 28
Accounts Receivable (–A) ..................................................... 1,400
Collected cash from customer.

3/28 Cash (+A) ............................................................................. 800
Accounts Receivable (–A) ..................................................... 800
Collected cash from customer.
b. The annual interest rate of forfeiting a cash discount is calculated as follows:
Annual rate = Cash discount rate x (365 days ÷ Number of days receipt collected after the end of the discount period)
= 2% x (365 ÷ 10 days)
= 73%
Since BBB can borrow money at an annual interest rate of 9%, BBB should have borrowed money at the 9% rate and paid its obligation to QNI Corporation. BBB would have saved itself some interest costs by borrowing the money rather than forfeiting the cash discount.

P6–3

a. 2010
Allowance for Doubtful Accounts (+A)................................................. 6,000
    Accounts Receivable (–A)...................................................... 6,000
Wrote off accounts deemed uncollectible.

Bad Debt Charge (E, –SE) ............................................................... 5,400*
    Allowance for Doubtful Accounts (–A).................................. 5,400
Recognized bad debt charge.

* $5,400 = Credit sales of $180,000 x Estimated uncollectible percentage of 3%

2011
Allowance for Doubtful Accounts (+A)................................................. 10,000
    Accounts Receivable (–A)...................................................... 10,000
Wrote off accounts deemed uncollectible.

Bad Debt Charge (E, –SE) ............................................................... 6,000*
    Allowance for Doubtful Accounts (–A)................................ 6,000
Recognized bad debt charge.

* $6,000 = Credit sales of $200,000 x Estimated uncollectible percentage of 3%

2012
Allowance for Doubtful Accounts (+A)................................................. 11,000
    Accounts Receivable (–A)...................................................... 11,000
Wrote off accounts deemed uncollectible.

Bad Debt Expense (E, –SE) .............................................................. 6,150*
    Allowance for Doubtful Accounts (–A)................................. 6,150
Recognized bad debt charge.

* $6,150 = Credit sales of $205,000 x Estimated uncollectible percentage of 3%
### P6–3 Concluded

**b.**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 2010 balance</td>
<td>$10,000</td>
</tr>
<tr>
<td>Write-offs during 2010</td>
<td>(6,000)</td>
</tr>
<tr>
<td>2010 bad debt charge</td>
<td>5,400</td>
</tr>
<tr>
<td>December 31, 2010 balance</td>
<td>$9,400</td>
</tr>
<tr>
<td>Write-offs during 2011</td>
<td>(10,000)</td>
</tr>
<tr>
<td>2011 bad debt charge</td>
<td>6,000</td>
</tr>
<tr>
<td>December 31, 2012 balance</td>
<td>$550</td>
</tr>
</tbody>
</table>

**c.**

CNG should consider increasing the percentage of credit sales that is considered uncollectible. From 2010 through 2012, write-offs exceeded bad debt expense, with the difference increasing over time. Write-offs as a percentage of credit sales increased from 3.33% ($6,000 ÷ $180,000) in 2010 to 5.37% ($11,000 ÷ $205,000) in 2012. This trend indicates that the December 31, 2012 balance in Allowance for Doubtful Accounts is probably understated, thereby causing an overstatement of the company’s assets. A more appropriate bad debt percentage would be 4.5% to 5.0% of credit sales.

### P6–4

**a.**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bad Debt Charge (E, –SE)</td>
<td>49,500*</td>
</tr>
<tr>
<td>Allowance for Doubtful Accounts (−A)</td>
<td>49,500</td>
</tr>
</tbody>
</table>

*Recognized bad debt expense.*

* $49,500 = Net sales x 3% = ($1,800,000 − $130,000 − $20,000) x 3%

**b.**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ending Allowance balance</td>
<td></td>
</tr>
<tr>
<td>= Beginning Allowance balance + Bad Debt Charge + Recoveries − Write-Offs</td>
<td></td>
</tr>
<tr>
<td>= $65,000 + $49,500 (from Part [a]) + $0 − $70,000</td>
<td></td>
</tr>
<tr>
<td>= $44,500</td>
<td></td>
</tr>
</tbody>
</table>

**c.**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bad Debt Expense (E, –SE)</td>
<td>40,500*</td>
</tr>
<tr>
<td>Allowance for Doubtful Accounts (−A)</td>
<td>40,500</td>
</tr>
</tbody>
</table>

*Recognized bad debt expense.*

* $40,500 = Net sales x 3% = ($1,500,000 − $100,000 − $50,000) x 3%

**d.**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ending Allowance balance</td>
<td></td>
</tr>
<tr>
<td>= Beginning Allowance balance + Bad Debt Expense + Recoveries − Write-Offs</td>
<td></td>
</tr>
<tr>
<td>= $44,500 (from Part [b]) + $40,500 (from Part [c]) + $0 − $85,000</td>
<td></td>
</tr>
<tr>
<td>= $0</td>
<td></td>
</tr>
</tbody>
</table>
a. Ending Allowance balance = Beginning Allowance balance + Bad Debt Charge + Recoveries – Write-Offs

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Allowance</th>
<th>Bad Debt Charge</th>
<th>Recoveries</th>
<th>Write-Offs</th>
<th>Ending Allowance Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$0</td>
<td>$4,200</td>
<td>$0</td>
<td>$3,000</td>
<td>$1,200</td>
</tr>
<tr>
<td>2011</td>
<td>$1,200</td>
<td>$7,600</td>
<td>$0</td>
<td>$6,000</td>
<td>$2,800</td>
</tr>
<tr>
<td>2012</td>
<td>$2,800</td>
<td>$9,600</td>
<td>$0</td>
<td>$8,400</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

b. Ending A/R balance = Beginning A/R balance + Credit Sales - Cash Collections – Write-Offs

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning A/R balance</th>
<th>Credit Sales</th>
<th>Cash Collections</th>
<th>Write-Offs</th>
<th>A/R (net)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$0</td>
<td>$105,000</td>
<td>$92,000</td>
<td>$3,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>2011</td>
<td>$10,000</td>
<td>$190,000</td>
<td>$161,000</td>
<td>$6,000</td>
<td>$33,000</td>
</tr>
<tr>
<td>2012</td>
<td>$33,000</td>
<td>$240,000</td>
<td>$214,000</td>
<td>$8,400</td>
<td>$50,600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>A/R (net)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>$10,000 - $1,200 = $8,800</td>
</tr>
<tr>
<td>2011</td>
<td>$33,000 - $2,800 = $30,200</td>
</tr>
<tr>
<td>2012</td>
<td>$50,600 - $4,000 = $46,600</td>
</tr>
</tbody>
</table>

c. In each of the three years shown, Albertson’s Locksmith Corporation has estimated bad debts slightly higher than the annual write-offs. The estimates are adequate and provide some cushion for future years in case of a larger-than-anticipated write-off.
The 2008 provision (an expense based on an estimate of uncollectible receivables) jumped significantly due to the start of a recession. During poor economic times, banks will have more difficulty collecting loans; the higher provision and the higher balance in the allowance account reflect the economic realities of 2008-2009.

P6–7

a.

Hadley Company

Income Statement
For the Year Ended December 31, 2011

<table>
<thead>
<tr>
<th>Item</th>
<th>2008</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td></td>
<td>102,000</td>
<td></td>
</tr>
<tr>
<td>Expenses</td>
<td>$115,000*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$ (17,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* $115,000 = $65,000 of previously reported expenses + $50,000 of bad debt expense associated with the Litzenberger account

Hadley Company
Balance Sheet
December 31, 2011

<table>
<thead>
<tr>
<th>Items</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Accounts receivable,</td>
<td>35,000</td>
</tr>
<tr>
<td>net</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>40,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 80,000</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities &amp; Stockholders' Equity</td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$ 13,000</td>
</tr>
<tr>
<td>Long-term notes payable</td>
<td>80,000</td>
</tr>
<tr>
<td>Stockholders' equity</td>
<td>(13,000)</td>
</tr>
<tr>
<td>Total liabilities and</td>
<td></td>
</tr>
<tr>
<td>stockholders' equity</td>
<td>$ 80,000</td>
</tr>
</tbody>
</table>

After considering the adjustment for potential bad debts, Hadley generated a net loss for 2011. Therefore, it appears that Hadley Company did not have a very successful first year of operations.

a. Auditors have their own interests. They must consider factors affecting their own well-being. One item that could adversely affect auditors' well-being is being the defendant in a lawsuit. If the auditors did not require an adjustment for the Litzenberger account, and Litzenberger was subsequently unable to pay its debt, users of Hadley's financial statements could sue the auditors for any losses incurred. Conservatism, which states "when in doubt, understate rather than overstate," applies to this situation. Since the auditors are uncertain as to whether Hadley Company will ever collect the money from Litzenberger, the auditors would prefer to understate Hadley Company's financial health rather than overstate it.
Concluded

b. While it is true that Litzenberger is still operating, Hadley's CFO is ignoring the revenue recognition principle and the matching principle. Under the revenue recognition principle, revenue should not be recognized if post-sales costs cannot be adequately estimated (subject to materiality). In this case, the actual bad debt cost associated with Litzenberger will not occur until a subsequent period. However, if this cost cannot be adequately estimated, Hadley Company should not even recognize the revenue from the sale to Litzenberger. Assume that Hadley Company can adequately estimate the bad debt cost. In this case Hadley Company is allowed to recognize the revenue. But under the matching principle, all costs associated with generating revenue should be matched against that revenue. Hence, any costs associated with making a sale, whether incurred in the current period or in subsequent periods, should be recorded in the period of the sale. Since the bad debt cost is associated with generating revenue, Hadley Company should record the bad debt cost in the current period as an expense.

P6–8

a. The effect of the auditors’ findings on 2011 Fees Earned, Accounts Receivable, Allowance for Doubtful Accounts, current ratio, working capital, and net income can be determined as follows.

Fees Earned: Fees Earned would decrease from $240,000 to $230,000.

Accounts Receivable: Accounts Receivable would decrease from $68,000 to $58,000.

Allowance for Doubtful Accounts: This account should have a balance equal to 10% of the new Accounts Receivable balance. The correct balance would be $5,800, or an increase of $2,400.

Current Ratio: The current ratio before the auditors’ findings was 1.62 ($105,000 ÷ $65,000). Current assets after adjusting for the auditors’ findings would be $92,600 ($105,000 – $10,000 decrease in Accounts Receivable – $2,400 increase in Allowance for Doubtful Accounts). Current Liabilities would be unaffected by the auditors’ findings. Thus, the new current ratio would be 1.42 ($92,600 ÷ $65,000).

Working Capital: Working capital would decrease from $40,000 ($105,000 – $65,000) to $27,600 ($92,600 – $65,000).

Net Income: Net income would decrease by the reduction in Fees Earned of $10,000 and by the increase in Bad Debt Charge of $2,400. The new net income would be $2,600.

b. Prior to the auditors’ findings, Finley, Ltd. was in compliance with its debt covenants. However, after adjusting the books for the auditors’ findings, Finley, Ltd. has violated both requirements of its debt covenants. The company’s current ratio has fallen to 1.42, which is below 1.5 as specified in the loan agreement. Further, the company declared dividends equal to 192.3% of the adjusted net income. It appears that one possible explanation for Finley’s decision to record the sale and not record an adequate amount for bad debts was to avoid violating its debt covenants.
P6–9

a. 

<table>
<thead>
<tr>
<th>Method</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Method</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bad debt charge</td>
<td>$10,000</td>
<td>$50,000</td>
<td>$20,000</td>
<td>$80,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>Accounts rec. value</td>
<td>950,000</td>
<td>900,000</td>
<td>1,200,000</td>
<td>1,175,000</td>
<td>1,095,000</td>
</tr>
<tr>
<td><strong>Allowance Method</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bad debt charge</td>
<td>$80,000</td>
<td>$78,000</td>
<td>$82,000</td>
<td>$82,560</td>
<td>$79,200</td>
</tr>
<tr>
<td>Accounts rec. value</td>
<td>880,000</td>
<td>802,000</td>
<td>1,040,000</td>
<td>1,012,440</td>
<td>943,240</td>
</tr>
</tbody>
</table>

**Note:** Under the allowance method, the net value of Accounts Receivable equals the balance in Accounts Receivable less the balance in Allowance for Doubtful Accounts.

b. 

<table>
<thead>
<tr>
<th>Method</th>
<th>Current Method</th>
<th>Allowance Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total bad debt charge</td>
<td>$250,000</td>
<td>$401,760</td>
</tr>
</tbody>
</table>

The allowance method provides a measure of net income consistent with both the revenue recognition and the matching principles. Over the five-year period Fine Linen Service wrote off a total of $250,000 in Accounts Receivable from sales made in prior years. Under the current method, the $250,000 did not reduce revenue in the year of the sale. Hence, net income in each individual year was misstated. Under the allowance method, bad debt expense is calculated using the year's sales. Consequently, the allowance method, while an estimate, provides better matching of expenses with the associated revenues.

P6–10

a. 

<table>
<thead>
<tr>
<th>Bad Debt Charge (E, –SE)</th>
<th>15,000*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for Doubtful Accounts (–A)</td>
<td>15,000</td>
</tr>
</tbody>
</table>

*Estimated bad debt charge.

* $15,000 = $750,000 December credit sales x 2% Estimated uncollectible percentage

b. 

Ending allowance balance = Beginning allowance balance + Annual bad debt charge + Recoveries – Write-offs

= $70,000 + ($11,940,000 x 2%) + $0 – $239,000

= $69,800

c. 

Ending accounts receivable balance = Beginning accounts receivable balance + Credit sales + Recoveries – Cash collections – Write-Offs

$3,250,000 (from the aging) = Beginning accounts receivable balance + $11,940,000 + $0 – $12,126,000 – $239,000

Beginning accounts receivable balance = $3,675,000
P6–10 Concluded

d. **Account Age**  | **Account Balance** | **Noncollection Probability** | **Uncollectible Amount**
---|---|---|---
Current | $700,000 | 2.0% | $14,000
1–30 days | 1,200,000 | 5.5% | 66,000
31–75 days | 550,000 | 10.0% | 55,000
> 75 days | 800,000 | 25.0% | 200,000
Total | | | $335,000

Bad Debt Charge (E, –SE) ............................................... 280,200*
   Allowance for Doubtful Accounts (–A)............................. 280,200

* $280,200 = $335,000 – Unadjusted Allowance balance
   = $335,000 – ($70,000 + $223,800 of monthly bad debt charge
   adjusting entries for January through November – $239,000 of
   accounts written off)

Estimate **bad debt charge.**

e. Some companies use the percent-of-sales method to estimate bad debts but also periodically
use the aging method. Companies would use the two methods for several reasons. The percent-
of-sales method is very easy and comparatively inexpensive to use. Further, the percent-of-sales
method emphasizes revenues and expenses, since estimated bad debts are a function of
revenues. For these reasons a company is more apt to use the percent-of-sales method than the
aging method.

Additionally, the aging method can be very costly and time-consuming. For all but the smallest
companies, preparing an aging of Accounts Receivable requires a computerized accounting
system. However, in return for this increased cost and time, the aging method provides several
types of useful information. First, the aging method identifies slow-moving accounts, which may
require additional collection efforts. Further, the dollar amount of any particular aging
classification dictates the maximum amount that the company should expend in trying to collect
the accounts. A company would generally not want to spend more to collect an account than it
expects to ultimately collect.

Second, an aging can help a company define its credit policies. For example, if an aging
identifies a particular customer as a consistently slow payer, the company may decide to no
longer extend credit to this customer. If an aging indicates a large percentage of old accounts,
this information could be used to decide whether to offer cash discounts and the terms of such
discounts.

Finally, an aging can indicate the accuracy of the percent-of-sales method. A detailed analysis of
Accounts Receivable will usually provide an accurate estimate for the required balance in
Allowance for Doubtful Accounts. This estimated balance can be compared to the balance
obtained using the percent-of-sales method. Significant differences would indicate a need to
revise the percent of sales considered uncollectible. To obtain this information, companies will
periodically prepare an aging of Accounts Receivable.
ISSUES FOR DISCUSSION

ID6–4

a. Allowance for Credit Losses

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for loan losses at beginning of year</td>
<td>$16,177</td>
<td>$8,940</td>
<td>$9,782</td>
</tr>
<tr>
<td>Provision for credit losses—consumer</td>
<td>28,282</td>
<td>15,599</td>
<td></td>
</tr>
<tr>
<td>Provision for credit losses—corporate</td>
<td>5,392</td>
<td>1,233</td>
<td></td>
</tr>
<tr>
<td>Consumer credit losses</td>
<td>10,645</td>
<td>8,629</td>
<td></td>
</tr>
<tr>
<td>Corporate credit losses</td>
<td>1,922</td>
<td>948</td>
<td></td>
</tr>
<tr>
<td>Consumer recoveries</td>
<td>1,661</td>
<td>1,547</td>
<td></td>
</tr>
<tr>
<td>Corporate recoveries</td>
<td>277</td>
<td>232</td>
<td></td>
</tr>
</tbody>
</table>

Across the three years, Citi is estimating more and more of its loans to be uncollectible. This trend is caused by the deteriorating economy that moved into a recession in 2008. Another trend of interest is the fact that in 2006 Citi underestimated its credit losses in both consumer and corporate but then in 2007 and again in 2008 the bank overestimated its losses (compare the provision lines to the losses lines). It appears that Citi recognized that its previous habit of underestimating had left its Allowance for Credit Losses too small to handle all the bad loans of a full-blown recession. By estimating so high in 2007 and 2008, the bank is setting itself to absorb the losses that may come in 2009 and beyond.

b. 2008 Loans | Net Write-Offs | %
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer loans</td>
<td>$519,673</td>
<td>$18,402</td>
</tr>
<tr>
<td>Corporate loans</td>
<td>174,543</td>
<td>1,773</td>
</tr>
</tbody>
</table>

The above information indicates that the Consumer loan portfolio is the riskier of the two.

ID6–6

The Provision for Loan Loss is the expense that feeds into a bank’s Allowance for Loan Losses, the contra asset account that adjusts downward the carrying value of the bank’s loan portfolio. When banks determine that their loans are less collectible, they bring the portfolio down in value by increasing the Allowance with a higher Provision on the Income Statement.

A weakened housing market directly affects the collateral that supports the bank’s first mortgage home loan. When a homeowner purchases a home by borrowing money from a bank, the bank takes the house as collateral. If the homeowner is unable to repay the loan, the bank has the right to seize the house (in a foreclosure) and sell the house to recover its money. If housing prices have dropped, the bank will receive less money from the sale of the foreclosed home and will therefore be less likely to recoup all of its cash. To deal with this potential loss, prudent
accounting calls for an increase in the Allowance (through the Provision on the Income Statement) to properly reflect the value of the loan.

In addition to the effect on the bank’s collateral, a weakened housing market may also affect the bank’s customers and their ability to repay their loans. If the housing market suffers, all the individuals who work in industries supporting that market (construction, real estate sales and development, mortgage lending, insurance, retail, etc.) will suffer and collectively will have less available cash flow for debt service. As discussed above, if bank customers have employment problems that weaken their monthly cash flow, the bank’s loans are less collectible and the bank will need to lower the value of the loans by increasing the Allowance through a Provision on the Income Statement.

Analysts will question a bank’s estimates of Uncollectibility because they understand that bank management has the incentive to keep earnings (and therefore the stock price) high. If a bank acknowledges problem loans, the bank will need to increase its Provision on the Income Statement—meaning the bank will report lower earnings. Analysts fear that bankers will understate problem loans in order to keep earnings high to support stock prices.

**ID6–9**

a. Sales concentration (having a large percentage of credit sales and accounts receivable with one customer) is a risk simply due to the fact that if the customer fails to pay its account then a large bad debt charge will significantly reduce earnings and operating cash flow. Having a large portion of business with one account puts a company in a vulnerable position if that customer fails. A better position would be to have receivables spread across many customers (in many different industries), lessening the impact if one customer fails to pay.

b. The failure of one large account would cause a company to increase its Allowance for Uncollectibles by taking a large Bad Debt Expense. Earnings, assets and equity would all decline.

**ID6–10**

a. The company could reduce its bad debt reserve from $6.5 million to $5.39 million because its actual writeoffs were lower than expected. If there was an increase in the credit quality of its loans it could support a reduction in the reserve for bad debts. It could also be reducing its reserve for bad debts because its reported earnings were going to be lower than expected, and management made a decision to lower its reserve in order to pump up earnings in the reported period.

In a year where sales have increased by 30% it is difficult to believe that the credit quality of its portfolio of loans has improved so much that there should be a reduction in the reserve account. If sales were flat in the reporting period this might be reasonable, but often when there is a significant increase in sales this increase may have been the result of lowering the credit standards so that more buyers could qualify to purchase time shares.

b. “that’s tomorrow’s problem?” means that in future years Fairfield may have to take very large charges for bad debts. By reducing its provision this year (when sales were up 30%), Fairfield may be setting themselves up to have to take a very large charge in order to increase reserves to the appropriate level relative to sales.