CHAPTER 6

THE CURRENT ASSET CLASSIFICATION, CASH, AND ACCOUNTS RECEIVABLE

BRIEF EXERCISES

BE6–1

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

2012 Total Accounts Receivable = $4,983 + $109
2012 Total Accounts Receivable = $5,092

2012 Uncollectibles as a Percentage of Total Accounts Receivable = $109/$5,092 = 2.14%

2011 Total Accounts Receivable = $4,502 + $104
2011 Total Accounts Receivable = $4,606

2011 Uncollectibles as a Percentage of Total Accounts Receivable = $104/$4,606 = 2.26%

Therefore, the percentage decreased.

b. Since Emerson Electric is using the percentage of accounts receivable method (balance sheet approach), bad debt expense for 2012 would be the amount needed to adjust the allowance for doubtful accounts to $109. 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. The changes to the Allowance account are:

Ending Allowance Balance = Beginning Allowance Balance + Bad Debt Charge – Write-Offs + Recoveries

Therefore, the "increases" shown are the annual bad debt expenses. For 2011 the amount was $3,795 million, while the amount in 2012 was a very close $3,793 million. Unlike other time periods, 2011 and 2012 were both economic recovery periods, indicating that the company’s credit issues with customers were similar.

b. 2011:

$7,139 million write-offs; $5,524 million write-offs, net of recoveries of previous write-offs

2012:

$6,582 million write-offs; $4,998 million write-offs, net of recoveries of previous write-offs
c. The allowance account decreased by 19.5% from 2011 to 2012. Although the annual expense for bad debts and recoveries were very similar, the amount written off (due to specific knowledge of a customer’s situation) decreased more substantially. Perhaps GE has dealt with many of its problem-paying customers in the early part of the economic recovery, leaving less issues to be cleaned up.

BE6–3

a. GE bad debts as a percentage of total revenues = $3.9/$147 = 2.7%; as a percentage of GECS revenues, the calculation is $3.9/$46 = 8.5%. GE overall revenues should be used since the bad debt provision is for GE and not for GECS.

b. On a balance sheet for GECS accounts receivable would be expected to be the largest account. Its primary role is as a financing company, and the receivables from the buyers of appliances would be a large asset of GECS.

c. GE is very large and has many subsidiaries that make it difficult to classify it as just a manufacturing, retail or service company. The overall GE business is best known as a manufacturing company. It does not have its own retail stores, so it is not a retailer. While there are many services offered with its products, its primary focus is as a manufacturer. Services, primarily financial services, were becoming more important for the consolidated operation prior to the economic crisis, but senior management has pledged to reduce the importance of financing revenue in future years.

EXERCISES

E6–1

a. Cash. Money held in checking accounts is defined as cash, and there are no restrictions on the account.

b. Cash. Checks are considered cash unless the checks cannot be cashed until a later date (i.e., postdated). In this case, the check date has passed, so the checks are considered cash.

c. Investment. Certificates of deposit contain penalties for early withdrawal. Since the certificates mature outside the time frame of current assets, this source of cash is not readily available and should not be classified as Cash.

d. Cash. Because banks have the right to demand notice prior to a withdrawal from a savings account, the cash in savings accounts is technically not readily available. However, since banks rarely exercise this right, savings accounts are considered cash.

e. Cash. Petty cash is always considered cash.

f. Restricted cash. Because the company does not have ready access to these funds, the $50,000 should not be reported as cash. The portion of the $50,000 corresponding to short-term loans (i.e., $15,000) should be classified in current assets as restricted cash, and the remaining $35,000 should be classified as a long-term investment or as an other asset.

g. Cash. See (a).

E6–2

a. unrestricted cash  d. investment  g. unrestricted cash

b. investment  e. investment

c. restricted cash  f. restricted cash
E6–3

a.  
12/12  Accounts Receivable (+A) ........................................... 40,000  
     Sales (R, +SE) .................................................. 40,000  
     *Made sale on account.*

1/5  Cash (+A) .......................................................... 40,000  
     Accounts Receivable (–A) ..................................... 40,000  
     *Collected cash from customer.*

b.  
12/20  Cash (+A) ..................................................... 39,200  
     Cash Discount (–R, –SE) ..................................... 800  
     Accounts Receivable (–A) ..................................... 40,000  

The timing of the cash receipts would affect the income statement due to the cash discount. Cash discount is a contra sales account and is deducted from the sales revenue. Therefore, the net income is reduced by the amount of the cash discount during year 1 in case (b).

Under option (a) the statement of Cash Flows will show no inflow during year 1, but during year 2 it will show an inflow from operating activities of $40,000. Under option (b) no inflow from operating activities will be shown in year 2, but during year 1 there will be an increase of $39,200 from operating activities.

E6–4

5/1/15  Accounts Receivable (+A) ........................................... 30,000  
     Sales (R, +SE) .................................................. 30,000  
     *Sold lobster on account.*

5/5/15  Accounts Receivable (+A) ........................................... 20,000  
     Sales (R, +SE) .................................................. 20,000  
     *Sold cod on account.*

5/6/15  Cash (+A) .......................................................... 29,100  
     Cash Discount (–R, –SE) ..................................... 900  
     Accounts Receivable (–A) ..................................... 30,000  
     *Collected cash from customer.*

5/31/15  Cash (+A) .......................................................... 20,000  
     Accounts Receivable (–A) ..................................... 20,000  
     *Collected cash from customer.*

E6–5

<table>
<thead>
<tr>
<th>Allowance for Uncollectibles</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014 Write-Offs</td>
</tr>
<tr>
<td>12/31/14</td>
</tr>
<tr>
<td>Bad Debt Expense</td>
</tr>
</tbody>
</table>

1


2015 Write-Offs 22,000  
Bad Debt Expense 28,000

\[
\text{Ending Balance} = \frac{1}{2} (1,500,000 \times 0.02) = 30,000
\]

\[
\text{Ending Balance} = \frac{1}{2} (1,400,000 \times 0.02) = 28,000
\]

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

\[
\begin{align*}
$200,000 &= \text{Beginning Allowance Balance} + $162,500 - $195,000 + $45,000 \\
\text{Beginning Allowance Balance} &= $187,500
\end{align*}
\]

* $162,500 = Sales of $3,250,000 \times \text{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.

\[
\begin{align*}
$7,500,000 &= X + $3,250,000 - $4,200,000 - $195,000 + $45,000 \\
X &= $8,600,000
\end{align*}
\]

E6–7

a. Bad Debt Charge (E, –SE) ................................................................. 6

Allowance for Doubtful Accounts (–A) ........................................... 6

*Recognized bad debt charge.*

b. Ending Allowance Balance = Beginning Allowance Balance + Bad Debt Charge – Write-Offs + Recoveries

\[
\begin{align*}
&= $12 + $6 - $5 + $0 \\
&= $13
\end{align*}
\]

E6–8

a. Ending Allowance Balance = Beginning Allowance Balance + Bad Debt Charge – Write-Offs + Recoveries

\[
\begin{align*}
$1,300 &= $1,000 + (\text{Sales of $75,300} \times \text{Estimated uncollectible percentage of 2%}) - \text{Write-Offs} + $55 \\
\text{Write-Offs} &= $1,261
\end{align*}
\]
### E6-9

**a.** Extending credit to customers (and therefore creating accounts receivable on the balance sheet) is a normal part of business operations. Therefore, the transactions related to receivables, such as uncollectibles and increases/decreases in gross receivables, are treated as operating activities.

**b.** The indirect format of the statement of cash flow is structured around converting net income (a number based in accrual accounting) into a pure cash number. The provision is a non-cash charge, similar to depreciation expense, that reduces net income but does not (by itself) reduce the company’s cash balance. Therefore, the non-cash expense is added back to net income in the calculation of cash from operating activities. The fact that receivables decreased indicates that the company collected more cash than just the amount in its current year sales—effectively, the company collected this year’s sales and some of last year’s (that were sitting as accounts receivable on the balance sheet). If receivables had increased, the company would have deducted that amount in the statement of cash flow (because the company would not have collected as much cash as it had booked in sales). The decrease in receivables is called a “source” of cash (while an increase would be called a “use” of cash).

**c.** Net cash from operating activities can be higher than net income because of non-cash expenses (as discussed above) and because of decreases in current assets (“sources” of cash as discussed above) or increases in current liabilities (also “sources” of cash). If “uses” of cash (such as increases in current assets and decreases in current liabilities) had been larger, net cash from operating activities may have been lower than net income.
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>

* $10,450 = Sales in Canadian dollars of 11,000 x Exchange rate of $0.95/Canadian dollar

* $440 = Adjusted value of note – Carrying value of note
  = (Note for 11,000 Canadian dollars x Current exchange rate of $0.99/Canadian dollar) – $10,450

* $990 = Adjusted value of note – Carrying value of note
  = (Note for 11,000 Canadian dollars x Current exchange rate of $0.90/Canadian dollar) – $10,890

E6–11

1/1/15 Notes Receivable (+A) ........................................... 10,450*
  Sales (R, +SE) .......................................................... 10,450
  * Made sale in exchange for a note.

12/31/15 Notes Receivable (+A) ........................................... 440*
  Exchange Gain (Ga, +SE) .............................................. 440
  * Recorded foreign currency exchange gain on receivable.

12/31/16 Exchange Loss (Lo, –SE) ....................................... 990*
  Notes Receivable (–A) .................................................. 990
  * Incurred foreign currency exchange loss on receivable.

E6–12

January 1, 2015
Notes Receivable (+A) ........................................... 10,450*
  Sales (R, +SE) .......................................................... 10,450
  * Made sale in exchange for a note.
Cash (+A) ........................................................................................................ 10,450*

Notes Payable (+L) ................................................................................... 10,450

Recorded borrowing (in Canadian dollars).

* $10,450 = Note balance of 11,000 Canadian dollars x Exchange rate of $0.95/Canadian dollar

**December 31, 2015**

Notes Receivable (+A) ................................................................................... 440*

Exchange Gain (Ga, +SE) ............................................................................. 440

Earned a foreign currency exchange gain on receivable.

Exchange Loss (Lo, –SE) ................................................................................ 440*

Notes Payable (+L) ................................................................................... 440

Inceded a foreign currency exchange loss on payable.

* $440 = Adjusted value of note – Carrying value of note

= (Note for 11,000 Canadian dollars x Current exchange rate of $0.99/Canadian dollar) – $10,450

**December 31, 2016**

Exchange Loss (Lo, –SE) ................................................................................ 990*

Notes Receivable (–A) ................................................................................ 990

Inceded a foreign currency exchange loss on receivable.

Notes Payable (–L) ................................................................................... 990*

Exchange Gain (Ga, +SE) ............................................................................. 990

Earned a foreign currency exchange gain on payable.

* $990 = Adjusted value of note – Carrying value of note

= (Note for 11,000 Canadian dollars x Current exchange rate of $0.90/Canadian dollar) – $10,890

Exchange gains and losses on debt and receivables for the same amount and expressed in the same foreign currency always offset each other. When the exchange rate increases, both the receivable and the payable increase by the same amount. The increase in the receivable gives rise to a gain (i.e., the company will receive more U.S. dollars), while the increase in the liability gives rise to a loss (i.e., the company must pay out more U.S. dollars). When the exchange rate decreases, both the receivable and the payable decrease by the same amount. The decrease in the receivable gives rise to a loss, while the decrease in the liability gives rise to a gain. Therefore, through hedging Outreach Inc. is able to avoid wide fluctuations in its net income from fluctuations in exchange rates.
PROBLEMS

P6–1

a. No. The $285,000 is comprised of the $225,000 in savings and checking accounts and the $60,000 compensating balance. The $225,000 can properly be classified as a current asset, since no restrictions on the access or on the use of these funds exist. However, Print-O-Matic is restricted from using the $60,000 compensating balance. Whether restricted cash should be classified as a current or as a noncurrent asset depends on whether the restriction will end within the time frame of current assets or outside this time frame. In this case the $60,000 is restricted until the loan matures on October 1, 2019. Consequently, the $60,000 will not become available within the time frame of current assets, thereby not qualifying the $60,000 for classification as a current asset. The $60,000 should be classified as a noncurrent asset.

b. The concept of interest expense is viewed differently by economists and accountants. Economists would define interest expense as the total cost of borrowing. Such costs would include the actual interest charged on the borrowing plus an opportunity cost incurred from borrowing. In this case, the actual interest charged on the borrowing for 2014 was $6,250. Print-O-Matic also incurred an opportunity cost. By borrowing the money, the company lost the opportunity to invest the $60,000 compensating balance. Assuming that Print-O-Matic would have invested this money in its savings and checking accounts at an annual rate of 6%, the company incurred an opportunity cost of $900 (i.e., $60,000 x 6% x 1/4). The opportunity cost should be considered when making business decisions.

Accountants would define interest expense as the outflow of assets or the inflow of liabilities associated with borrowing. Since opportunity costs represent lost opportunities and do not represent outflows of assets or inflows of liabilities, opportunity costs are not properly classified as expenses. Consequently, accountants would classify only the $6,250 as interest expense for 2014.

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.
P6–2  Concluded
3/29  Accounts Receivable (+A) .................................................. 1,800
      Sales (R, +SE) .......................................................... 1,800
      Made sale on account.

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. 2013
   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%

   2014
   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%

   2015
   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. January 1, 2013 balance..................................................  $10,000
   Write-offs during 2013........................................................ (6,000)
   2013 bad debt charge .......................................................  5,400

   December 31, 2013 balance.................................................  $ 9,400
   Write-offs during 2014.......................................................... (10,000)
   2014 bad debt charge .......................................................  6,000

   December 31, 2014 balance.................................................  $ 5,400
   Write-offs during 2015........................................................ (11,000)
   2015 bad debt charge .......................................................  6,150

   December 31, 2015 balance................................................  $  550

c. CNG should consider increasing the percentage of credit sales that is considered uncollectible. From 2013 through 2015, 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 2013 to 5.37% ($11,000 ÷ $205,000) in 2015. This trend indicates that the December 31, 2015 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. Bad Debt Charge (E, –SE)..................................................  49,500*
   Allowance for Doubtful Accounts (–A)..................................  49,500

   Recognized bad debt expense.

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

b. Ending Allowance balance = Beginning Allowance balance + Bad Debt Charge + Recoveries – Write-Offs
   = $65,000 + $49,500 (from Part [a]) + $0 - $70,000
   = $44,500

c. Bad Debt Expense (E, –SE) ...............................................  40,500*
   Allowance for Doubtful Accounts (–A)..................................  40,500

   Recognized bad debt expense.

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

d. Ending Allowance balance = Beginning Allowance balance + Bad Debt Expense + Recoveries – Write-Offs
   = $44,500 (from Part [b]) + $40,500 (from Part [c]) + $0 – $85,000
   = $0
a. Ending Allowance balance = Beginning Allowance balance + Bad Debt Charge + Recoveries – Write-Offs

2013 Ending Allowance Balance = $0 + $4,200* + $0 - $3,000
= $1,200

*2013 credit sales x .04

2014 Ending Allowance Balance = $1,200 + $7,600** + $0 - $6,000
= $2,800

**2014 credit sales x .04

2015 Ending Allowance Balance = $2,800 + $9,600*** + $0 - $8,400
= $4,000

***2015 credit sales x .04

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

A/R (net) = A/R balance – Allowance balance

2013 Ending A/R Balance = $0 + $105,000 - $92,000 - $3,000
= $10,000
2013 A/R (net) = $10,000 - $1,200 = $8,800

2014 Ending A/R Balance = $10,000 + $190,000 - $161,000 - $6,000
= $33,000
2014 A/R (net) = $33,000 - $2,800 = $30,200

2015 Ending A/R Balance = $33,000 + $240,000 - $214,000 - $8,400
= $50,600
2015 A/R (net) = $50,600 - $4,000 = $46,600

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 2010 provision (an expense based on an estimate of uncollectible receivables) was significantly higher due to the lingering 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. Since the recovery, the annual provision, write-offs and the ending balances have all declined.

Hadley Company
Income Statement
For the Year Ended December 31, 2014

Sales .......................................................... $ 200,000
Cost of goods sold ........................................... 102,000
Expenses ...................................................... 115,000*
Net income (loss) ........................................... $(17,000)

* $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, 2014

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

After considering the adjustment for potential bad debts, Hadley generated a net loss for 2014. Therefore, it appears that Hadley Company did not have a very successful first year of operations.

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.
P6–7  Concluded

c. 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 2014 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. Current Method

<table>
<thead>
<tr>
<th>Year</th>
<th>Bad Debt Charge</th>
<th>Accounts Receivable Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>$10,000</td>
<td>950,000</td>
</tr>
<tr>
<td>2012</td>
<td>$50,000</td>
<td>900,000</td>
</tr>
<tr>
<td>2013</td>
<td>$20,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td>2014</td>
<td>$80,000</td>
<td>1,175,000</td>
</tr>
<tr>
<td>2015</td>
<td>$90,000</td>
<td>1,095,000</td>
</tr>
</tbody>
</table>

Allowance Method

<table>
<thead>
<tr>
<th>Year</th>
<th>Bad Debt Charge</th>
<th>Accounts Receivable Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>$80,000</td>
<td>880,000</td>
</tr>
<tr>
<td>2012</td>
<td>$78,000</td>
<td>802,000</td>
</tr>
<tr>
<td>2013</td>
<td>$82,000</td>
<td>1,040,000</td>
</tr>
<tr>
<td>2014</td>
<td>$82,560</td>
<td>1,012,440</td>
</tr>
<tr>
<td>2015</td>
<td>$79,200</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. Total Bad Debt Charge

<table>
<thead>
<tr>
<th>Method</th>
<th>Current Method</th>
<th>Allowance Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</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. 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)

**Estimated 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.
P6–11

a. Looking at the net income for the years 2013, 2014, and 2015, it is true that Ticheley has reported profit increases consistently over the last three years. However, what remains to be seen is whether the increase in the profits is due to regular recurring operations or whether it is due to some income manipulation strategy adopted by Ticheley.

b. A company would establish such a system of rewarding the management only on the belief that an increase in return on Stockholders’ equity (Net Income as a % of total Stockholders’ Equity) would lead to an increase in the market price of its common stock. This belief is based on the fact that an increase in the market price of the company’s common stock (1) is what the investors are looking for and (2) is the true measure of the success of a company during any one year.

c. It appears that Ticheley is using an “income-smoothing” reporting strategy. Even though we have the data only for 3 years, the fluctuating bad debt change as a percentage of accounts receivables points to that conclusion.

<table>
<thead>
<tr>
<th>Year</th>
<th>Bad Debt Change as % of Accounts Receivables</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>2,100 ÷ 23,100 = 9.09%</td>
</tr>
<tr>
<td>2014</td>
<td>2,900 ÷ 23,200 = 12.50%</td>
</tr>
<tr>
<td>2015</td>
<td>1,700 ÷ 27,400 = 6.20%</td>
</tr>
</tbody>
</table>

d. Ticheley is probably using the “income-smoothing” reporting strategy to demonstrate to its stockholders that it is steadily growing. The company is setting aside more than normal (i.e., 12.5%) charge for bad debt expenses during a good year (i.e., 2014) and by dipping into the charge to cover the bad debt losses during the not so good year (i.e., 2015).

P6–12

<table>
<thead>
<tr>
<th>Value of Transaction</th>
<th>Value of Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>In Foreign Currency</td>
<td>Exchange Rate</td>
</tr>
<tr>
<td>(1) 320,000 pounds</td>
<td>1 dollar/0.50 pound</td>
</tr>
<tr>
<td>(2) 350,000 yen</td>
<td>1 dollar/125 yen</td>
</tr>
<tr>
<td>(3) 500 euros</td>
<td>1 dollar/0.75 euro</td>
</tr>
<tr>
<td>(4) 200,000 Canadian dollars</td>
<td>1 dollar/1.10 Canadian dollar</td>
</tr>
</tbody>
</table>

b. (1) Accounts Receivable (+A) .......................... 640,000  
   Sales (R, +SE) ........................................ 640,000  
   Made a sale on account expressed in British pounds.

(2) Notes Receivable (+A) .......................... 2,800  
   Sales (R, +SE) ........................................ 2,800  
   Sold a note expressed in yen.

(3) Inventory (+A) .......................... 666.67  
   Notes Payable (+L) .................................... 666.67  
   Purchased inventory for a note expressed in euros.
P6–12 Concluded

(4) Inventory (+A) .......................................................... 181,818.18
Accounts Payable (+L) .................................................. 181,818.18

Purchased inventory on account expressed in Canadian dollars.

c. Adjusted Value Carrying Value Exchange Gain (Loss)
   (1) $533,333.33a $640,000.00 ($106,666.67)
   (2) 3,043.48b 2,800.00 243.48
   (3) 588.24c 666.76 (78.43)
   (4) 190,476.19d 181,818.18 8,658.01

a $533,333.33 = 320,000 pounds x (1 dollar/.6 pound)
b $3,043.48 = 350,000 yen x (1 dollar/115 yen)
c $588.24 = 500 euro x (1 dollar/.85 euro)
d $190,476.19 = 200,000 Canadian x (1 dollar/1.05 Canadian)

d. Receivables and payables are stated in a particular currency, for example, in British pounds. Assume that money from the receivable/payable is to be converted into U.S. dollars. At a given point in time, one British pound can be converted into a certain number of dollars. These dollars can, in turn, be used to purchase items. At a different point in time, one British pound can be converted into a different number of dollars. Holding everything else constant, these dollars can now be used to purchase either more or less goods than before. This change in purchasing power affects a company's wealth. Changes in wealth are captured by gains and losses. Since these gains or losses arise due to fluctuations in exchange rates, they are aptly called exchange gains or exchange losses.

P6–13

a. Carrying value of receivable = Receivable in British pounds x Exchange rate
   = 40,000 British pounds x ($1.70/1 British pound)
   = $68,000

b. The current ratio is calculated as current assets divided by current liabilities. If International Services is to maintain a current ratio of at least 1.5, its current assets after considering the effect of exchange-rate fluctuations must be 1.5 times its current liabilities. The company's current assets not affected by exchange-rate fluctuations are $12,000 ($80,000 – $68,000 from Part [a]). Therefore, the minimum acceptable exchange rate would be calculated as follows:

\[
\frac{(\text{Current assets not affected by exchange rates} + \text{Current assets affected by exchange rates})}{\text{Current liabilities}} = 1.5
\]

\[
= \frac{($12,000 + \text{Current assets affected by exchange rates})}{\$50,000} = 1.5
\]

\[
= \frac{[$12,000 + (\text{Receivable in British pounds x Exchange rate})]}{\$50,000} = 1.5
\]

\[
= \frac{[$12,000 + (40,000 pounds x Exchange rate)]}{\$50,000} = 1.5
\]

Exchange rate = 1.575
P6–13 Concluded

c. For International Services to maintain a current ratio of at least 1.5, its current assets after considering the effect of exchange-rate fluctuations must be 1.5 times its current liabilities adjusted for the effects of exchange-rate fluctuations. The company’s current liabilities not affected by exchange-rate fluctuations are $48,400 ($50,000 - $1,600 payable to British bank). Therefore, the minimum acceptable exchange rate would now be calculated as follows:

$\frac{\text{Current assets not affected by exchange rates + Current assets affected by exchange rates}}{\text{Current liabilities not affected by exchange rates + Current liabilities affected by exchange rates}} = 1.5$

\[
= (\$12,000 + \text{Current assets affected by exchange rates}) ÷ (\$48,400 + \text{Current liabilities affected by exchange rates}) = 1.5
\]

\[
= \left[\$12,000 + (\text{Receivable in British pounds x Exchange rate})\right] ÷ \left[\$48,400 + (\text{Payable in British pounds x Exchange rate})\right] = 1.5
\]

\[
= \left[\$12,000 + (40,000 \text{ pounds x Exchange rate})\right] ÷ \left[\$48,400 + (1,000 \text{ pounds x Exchange rate})\right] = 1.5
\]

Exchange rate = 1.574 (rounded to 3 decimals)

d. Increases in the exchange rate cause exchange gains when holding receivables and exchange losses when holding payables. Alternatively, decreases in the exchange rate cause exchange gains when holding payables and exchange losses when holding receivables. Therefore, changes in the exchange rate have opposite effects on receivables and payables. By holding a payable in the same amount as a receivable, exchange gains will perfectly offset exchange losses. In this way, a company can hedge against exchange-rate fluctuations. A company never enjoys an exchange gain but also never incurs an exchange loss.
ISSUES FOR DISCUSSION

ID6–1

a. A potential investor is interested in the solvency of a company. Since solvency is associated with the availability of cash to pay off debts, an investor would want to know about any existing restrictions on a reported cash balance.

b. The difference is due to the length of time the cash is restricted in its use. If the cash will remain restricted for a time period longer than one year, it should be disclosed as noncurrent. If the cash will not be available to cover current obligations, then it would be inaccurate to designate the balance as current.

c. Excluding the cash balance will reduce working capital, the current ratio and the quick ratio. A user of the financial statements should rightly calculate that the solvency of the company is lowered due to the inability to use the restricted cash to cover current obligations.

d. If the company had not retired the debt, the 2012 statements would have continued to show the restrictions placed on the cash balances and, therefore, the amount of unrestricted cash would be less than what actually was shown.

ID6–2

a. For a long time, IBM rightfully enjoyed the reputation as the “epitome of financial conservatism”. This reputation was built by IBM by using conservative financial reporting practices. Such a reporting strategy underestimates the revenues and overestimates the expenses.

The maneuver by IBM to immediately record all the revenue from a long-term lease contract without realizing all the cash associated with the transaction is an example of liberal accounting policy (i.e., policy that tends to record the revenue as soon as possible).

Such maneuvers occurring too often will surely affect IBM’s reputation as the “epitome of financial conservatism.”

b. The use of accelerated revenue recognition methods has its own costs and benefits to IBM and its management.

Accelerated revenue recognition methods not only inflate the sales and net income on the income statement but also tend to inflate receivables on the balance sheet. Therefore, a number of ratios, such as return on stockholders’ equity, working capital, current ratio, and return on total assets are also inflated.

As a result of these inflated ratios, IBM may tend to gain in terms of its ability to comply with a number of provisions in its debt covenants. The cost of these benefits to IBM would be its image in the capital markets as the company that engages in the “window-dressing” of its financial statements. Such an impression about a company within the financial markets could lead to a higher level of scrutiny of its financial statements by financial analysts on one hand, and possibly a higher cost of capital to the firm on the other hand.

The major benefits to the management of adopting such an aggressive revenue recognition strategy would be (1) higher bonus, if based on net income or any other measure that involves net income or sales in the calculation; and (2) less pressure to worry about the credit ratings of
the debt. The major cost would be increased scrutiny by the auditors to ensure that management is not fraudulent.

c. IBM’s policy of requiring all employees to swear that they have read the company’s “Business Conduct Guidelines” is in direct contrast to its own behavior. On one hand it discourages its employees from organizing financial information in a potentially deceptive way, but on the other hand the management of the company engages in aggressive revenue recognition tactics to boost the bottom-line. This is a classic example of management not “walking the talk.” Such behavior is non exemplary and sends a very subtle signal to the employees that, during hard times, ethics have no place within the company.

ID6–3

a. Working Capital = Current Assets – Current Liabilities

1992: $1,256.20 – $1,087.5 = $168.70
1993: $1,067.60 – $1,105.1 = $(37.50)
1994: $1,253.60 – $1,259.1 = $(5.50)

According to the covenant, Quaker Oats Co. must maintain a Working Capital of more than $150 million. At the end of 1992, the company came very close to violating this restriction, as its Working Capital was only $168.70 million. Since then, the Working Capital has been negative, leading to the violation of the debt covenant during 1993 and 1994.

b. The 1994 annual report changes the restrictions from the Working Capital to the minimum Shareholders’ Equity. The new restrictions require the company to maintain a minimum shareholders’ equity of $300 million. It seems creditors want to protect their debt to the company, and by imposing the requirement of minimum share capital they are, in essence, securitizing their debt.
a. Allowance for Credit Losses

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2011</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for loan losses at beginning of year</td>
<td>$30,115</td>
<td>$40,655</td>
<td>$36,033</td>
</tr>
<tr>
<td>Provision for credit losses—consumer</td>
<td>9,796</td>
<td>10,254</td>
<td>35,494</td>
</tr>
<tr>
<td>Provision for credit losses—corporate</td>
<td>120</td>
<td>(756)</td>
<td>(13)</td>
</tr>
<tr>
<td>Consumer credit losses</td>
<td>16,838</td>
<td>21,164</td>
<td>31,073</td>
</tr>
<tr>
<td>Corporate credit losses</td>
<td>640</td>
<td>2,000</td>
<td>3,418</td>
</tr>
<tr>
<td>Consumer recoveries</td>
<td>2,485</td>
<td>2,740</td>
<td>2,638</td>
</tr>
<tr>
<td>Corporate recoveries</td>
<td>417</td>
<td>386</td>
<td>994</td>
</tr>
<tr>
<td>Allowance for loan losses at end of year</td>
<td>25,455</td>
<td>30,115</td>
<td>40,655</td>
</tr>
</tbody>
</table>

Across the three years, Citi is estimating less of its consumer loans to be uncollectible. Given the timing of the economic collapse and recovery, this trend is reasonable and to be expected. The company has taken into consideration the loans it will not be able to collect and adjusted its books accordingly. As consumers weather the storm of the economy, the company’s loan collection experience should improve.

b. 2012 Loans | Net Write-Offs | %

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer loans</td>
<td>$408,671</td>
<td>$14,353</td>
<td>3.51%</td>
</tr>
<tr>
<td>Corporate loans</td>
<td>246,783</td>
<td>223</td>
<td>0.09%</td>
</tr>
</tbody>
</table>

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

ID6–5

The Reserve for Loan Losses for a bank (or a mortgage company making home loans) is the same as the Allowance for Uncollectibles account for a company carrying accounts receivable from customers. The account is a contra asset account which lowers the carrying value of the loan portfolio to the amount that the company estimates it can actually collect. The account is increased when the lender takes an expense (often called a Provision for Loan Loss) to reflect the fact that addition loans have been granted and that collectability is not estimated to be 100%.

A company such as New Century might be reluctant to increase the Reserve because, as noted above, increasing the account is done through an expense to earnings. Increasing the account will have the immediate effect of reducing the company’s profits. In addition, in the specific case of New Century, an increased Reserve is an acknowledgement that the company extended credit to borrowers who are either unable or unwilling to repay the obligation. A sharp increase in the reserve is an admission of a flaw in the company’s business model. Investors in New Century, however, need to know the amount of loans that will not convert into cash.

Factors such as personal disposable income, housing prices, overall consumer debt levels and inflation will factor into loan defaults, especially in vulnerable markets such as sub-prime mortgage lending.

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.

**ID6–7**

a. The Bad Debt Provision is an expense that represents management’s estimate of future uncollectible receivables. Like other expenses, the provision can be found on the Income Statement.

b. The statement of cash flow reconciles net income (an accrual accounting number) with cash generated by the various areas of business activities. The operating section deals with those activities involved in the daily running of the business (like granting credit to clients and ultimately collecting cash), so activities related to receivables are included in the operating section. The provision is a non-cash expense which lowered net income for Target and Toyota but did not lower the cash levels for those companies. To convert net income into a cash number, the companies have added back those expenses (like the provision) that reduced earnings but did not reduce cash balances. The change to accounts receivable is included because the company collected a different dollar amount of cash than it booked as sales. In the case of Target and Toyota, the companies had an increase in receivables, meaning that they have not yet collected all the cash due from sales; the amount of the receivable increase is therefore subtracted away to help convert earnings to cash from operations.

c. Both companies have large non-cash expenses (such as depreciation and the provision) that will cause cash to be larger than earnings. In addition, current assets other than receivables (for these companies, mainly inventory) may have decreased in amount, effectively providing cash for the business. Finally, some current liabilities (such as trade payables) may have increased, effectively providing cash for the companies’ operations.

d. GAAP and IFRS treat receivables and bad debts in a very similar manner.
Selling on account to customers who will not ultimately pay cash for the purchase will boost sales and profits in the short-term but cause huge problems in the long-term. Many companies chase sales growth by granting credit (selling today with the promise of receiving cash tomorrow) to customers that have not demonstrated the ability to honor obligations. Sales will grow, but in future periods the benefit will be reduced when a large expense is booked to increase the Allowance for Uncollectibles account to cover the write-off of the bad receivable.

At the time of the sale, Assets (in the form of Accounts Receivable) and Equity (from Sales, which is closed into Net Income as part of Retained Earnings) increase. Also, if the company is correctly following the Matching Principle, a portion of the Receivable is booked as an expense and as an increase to the Allowance account. However, if the entire amount of the receivable is ultimately deemed to be uncollectible (because the company was granting credit to unworthy customers), then the Allowance will need to be significantly increased with another Bad Debt Expense (which will decrease Assets and Equity).

Accounts Receivable Days can be calculated by dividing the Accounts Receivable Turnover Ratio (discussed in Chapter 5) into 365 days. For example, an Accounts Receivable Turnover Ratio of 6.0 translates into Accounts Receivable Days of 60.83. The “days” represents the average time period it takes the company to collect the cash from the receivable. Low days indicates the company quickly converts the receivable into cash, while higher days implies the company is slow at collecting its cash.

Analysts can track a company’s collection period by calculating A/R Days to determine the “quality” of the company’s earnings. Profits that are boosted by receivables that will ultimately be uncollectible are of low quality. Tracking the collection period is an excellent tool to determine if the company’s stated profits will hold up over time.

d. 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.

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.

ID6–11

One of the issues in the recent real estate crisis was excess capacity, a situation caused by real estate developers building too many projects (often due to the easy access those developers had to capital). With too many projects built and not enough tenants to rent and occupy spaces, the real estate firms saw lower cash flow (both from vacant properties and from depressed rents in the properties that were occupied). With less cash flow the developers were less solvent, less able to meet their obligations. Firms such as Hill International that had extended credit to their developer clients were often left with a receivable that was uncollectible. As with banks and other companies that extend credit, when a receivable is uncollectible the company takes an expense (a provision for bad debts) that reduces the carrying amount of the receivable and reduces equity (through lowered retained earnings from the expense charged to income). An analyst following the industry could “link the chain” of cash flow problems, starting from tenants who pay lower rents to developers who default on payments (due to lower rent receipts) to support firms (such as Hill International) who have bad receivables and to banks who have extended credit to both developers and those firms that support the developers.

ID6–12

a. If a company holds receivables or payables stated in a foreign currency (as would be the case for companies that operate internationally), the receivables and payables must be converted to U.S. dollars when preparing financial statements. As the value of the U.S. dollar fluctuates relative to other currencies, the value of the receivables and payables in U.S. dollars also fluctuates. This gives rise to foreign currency gains and losses, which can result in substantial variations in income and other reported values from one reporting period to the next. In addition, foreign currency gains and losses have economic consequences in that they can affect a company's stock prices, credit ratings, debt covenants, and so forth. By centralizing the treasury function, a company can better monitor its overall exchange gains and losses. Without a centralized treasury function, a company may not realize it is incurring exchange gains and losses because nobody within the company realizes that it is their responsibility to monitor such items.
b. The main strategy many U.S. companies use to reduce the risks of holding receivables or payables stated in a foreign currency is hedging.

c. Hedging involves taking a position in a foreign currency in an equal and opposite amount to a particular receivable or payable stated in that currency. For example, if IBM had a receivable for 100,000 British pounds, it could hedge its position by creating a payable for 100,000 British pounds. The reason hedging protects a company is that any loss realized from holding a receivable when currency rates fluctuate will be perfectly offset from the gain realized from holding the payable, and vice versa.

Hedging is valuable to companies because without it companies would experience large fluctuations in income and reported receivables and payables. Unexpected fluctuations could cause a company to violate an existing debt covenant. Through hedging, companies are able to manage away such unexpected fluctuations and thereby decrease the chance that they will violate a debt covenant.

ID6–13

a. Google’s current ratio in 2012 was 4.22 ($60,454/$14,337), down from the 2011 level of 5.92. The company’s working capital in 2012 was $46,117 which changed from 2011’s working capital of $43,845. The changes that had the biggest impact on these numbers were the increases in Cash and Receivables and the decrease in Accounts Payable.

b. Cash and cash equivalents are included. Cash equivalents refer to any short term, highly liquid investments that have an original maturity of less than three months.

c. Google’s net receivables comprise 13.0% (10.3% in 2011) of Current Assets and 8.41% (7.48% in 2011) of Total Assets as of 12/31/2012. Receivables represent a significant investment by the company and are crucial to strong cash flow; the management of those receivables, therefore, is an important part of the company’s focus. The allowance for uncollectible receivables was $581 and $133 in 2012 and 2011, respectively.

The balance in the Allowance account represents 6.9% of total accounts receivable in 2012 (2.4% in 2011). The increase in the contra account would be of interest to analysts following the company, as cash collection receivables of ad revenue and Motorola hardware sales are the main source of operating cash for the company.

d. Footnote #15 indicates that 53.2% of Net Revenue comes from international sources. Google enters into forward hedging contracts to protect itself against fluctuations in foreign currencies. Translation gains and losses are reported in accumulated other comprehensive income, as part of stockholders’ equity.

e. The increase in accounts receivable is an operating activity (dealing with the daily extension of credit to and collection of cash from customers) that acted as a “use” of cash, meaning the company has yet to collect some of the receivables from the credit sales on the income statement.