



## Writing Off Specific Uncollectible Accounts

Step	Timing	Accounts Affected	Financial Statement Effects	
1. Record estimated bad debts adjustment	End of period in which sales are made	Bad Debt Expense (E)    ↑	Net Income	↓
		Allowance for Doubtful Accounts (XA)    ↑	Assets (Accounts Receivable, Net)	↓
2. Identify and write off actual bad debts	Throughout period as bad debts become known	Accounts Receivable (A)    ↓	Net Income	} No effect
		Allowance for Doubtful Accounts (XA)    ↓	Assets (Accounts Receivable, Net)	



## Estimation and Recording of Uncollectible Receivables



## Estimation of Uncollectible Receivables

An estimate of uncollectible accounts at the end of period is required at the end of period. This estimate is normally based on past experience, industry averages, and forecasts of the future.

The two methods used to estimate uncollectible accounts are as follows:

1. Percentage of Sales Method
2. Aging of Accounts Receivable Method



## Estimating Bad Debts - Percentage of Sales Method

Bad debt percentage is based on actual uncollectible accounts from prior years' credit sales.

Focus is on determining the amount to record on the income statement as Bad Debt Expense.



$$\begin{array}{r}
 \text{Net credit sales} \\
 \times \text{ \% Bad debt loss rate} \\
 \hline
 \text{Bad debt expense}
 \end{array}$$



## Estimating Bad Debts - Percentage of Sales Method

In 2010, Kid's Clothes had credit sales of €600,000.  
Past experience indicates that bad debts are **one percent of sales**.



What is the estimate of bad debts expense for 2010?

$$€600,000 \times 0.01 = €6,000$$

Prepare the adjusting entry.

GENERAL JOURNAL			
Date	Description	Debit	Credit
Dec. 31	Bad Debt Expense (+E,-SE)	6,000	
	Allowance for Doubtful Accounts (+XA,-A)		6,000
	To record bad debt expense.		

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## Estimating Bad Debts - Aging of Accounts Receivable Method

**Focus is on**  
**determining the desired balance in the Allowance for Doubtful Accounts**  
**on the statement of financial position.**

Each customer's account is aged  
by breaking down the balance  
by showing the age (in number of days) of each part of the balance.

An aging of accounts receivable for Kid's Clothes in 2010 might look like this . . .

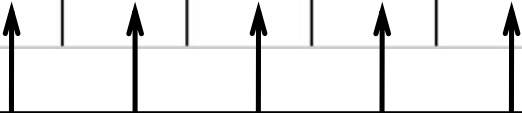
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## Aging Schedule

Customer	Not Yet Due	Days Past Due				Total A/R Balance
		1-30	31-60	61-90	Over 90	
Aaron, R.		€ 235				€ 235
Baxter, T.	€ 1,200	300				1,500
Clark, J.			€ 50	€ 200	€ 500	750
Zak, R.			325			325
<b>Total</b>	<b>€ 3,500</b>	<b>€ 2,550</b>	<b>€ 1,830</b>	<b>€ 1,540</b>	<b>€ 1,240</b>	<b>€ 10,660</b>
<b>% Uncollectible</b>	<b>0.01</b>	<b>0.04</b>	<b>0.10</b>	<b>0.25</b>	<b>0.40</b>	



Based on past experience,  
the business estimates the percentage of uncollectible accounts in each time category.  
These percentages are then multiplied by the appropriate column totals.



## Aging Schedule

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<b>% Uncollectible</b>	<b>0.01</b>	<b>0.04</b>	<b>0.10</b>	<b>0.25</b>	<b>0.40</b>	
<b>Estimated Uncoll. Amount</b>	<b>€ 35</b>	<b>€ 102</b>	<b>€ 183</b>	<b>€ 385</b>	<b>€ 496</b>	<b>€ 1,201</b>

The column totals are then added to arrive at the total estimate of uncollectible accounts of €1,201.

Record the Dec. 31, 2010 adjusting entry assuming that the Allowance for Doubtful Accounts currently has a €50 credit balance.





## Estimating Bad Debts - Aging of Accounts Receivable Method

GENERAL JOURNAL			
Date	Description	Debit	Credit
Dec. 31	Bad Debt Expense (+E,-SE)	1,151	
	Allowance for Doubtful Accounts (+XA,-A)		1,151
	To record bad debt expense.		

1,201	Desired balance
- 50	Credit balance
<b>€ 1,151</b>	<b>Adjusting entry</b>

After posting the above entry, the Allowance account would look like this . . .

Allowance for Doubtful Accounts (XA)	
	50 Balance at 12/31/2010 before adjustment
	1,151 2010 adjustment
	<b>1,201</b> Balance at 12/31/2010 after adjustment

Notice that the balance after adjustment is equal to the estimate of €1,201 based on the aging analysis performed earlier.



## Estimating Bad Debts - Aging of Accounts Receivable Method

➔

X Accounts Receivable  
% Estimated Uncollectible

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Desired Balance in Allowance Account

- Allowance Account **Credit** Balance

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Amount of Journal Entry

➔

X Accounts Receivable  
% Estimated Uncollectible

---

Desired Balance in Allowance Account

+ Allowance Account **Dedit** Balance

---

Amount of Journal Entry



## Receivables Turnover Ratio

$$\text{Receivables Turnover} = \frac{\text{Net Sales}}{\text{Average Net Trade Receivables}}$$

This ratio measures how many times average receivables are recorded and collected for the year.

adidas reported 2009 net sales of €10,381,000.  
December 31, 2008, receivables were €1,624,000 and  
December 31, 2009, receivables were €1,429,000.

$$\text{Receivables Turnover} = \frac{€10,381,000}{(€1,429,000 + €1,624,000) \div 2} = 6.8 \text{ times}$$



## Average Collection Period

$$\text{Average Collection Period} = \frac{365}{\text{Receivables Turnover}}$$

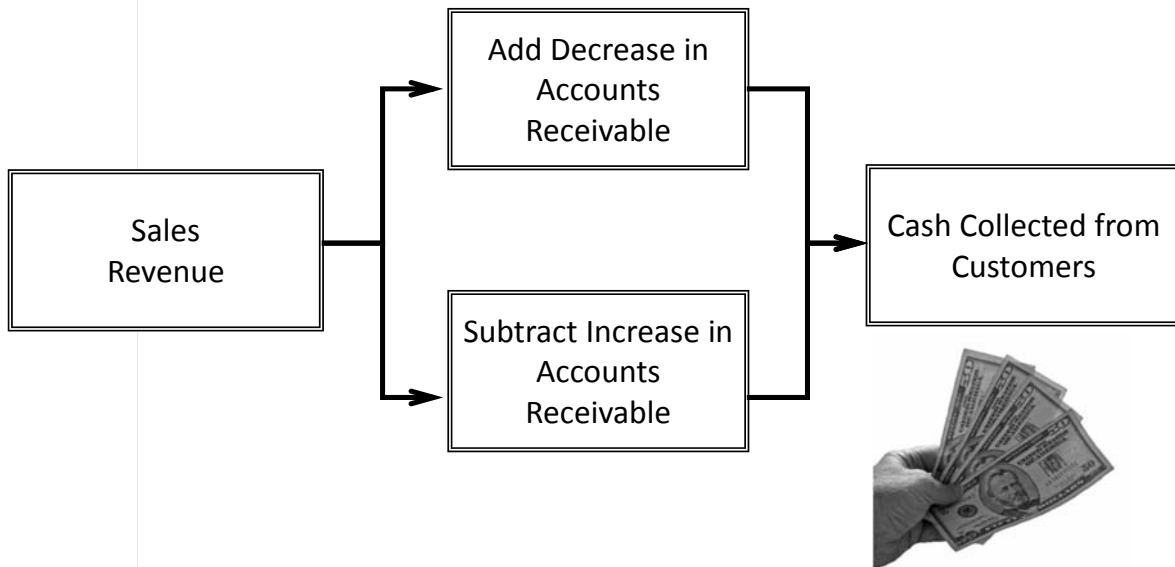
This ratio indicates the average time it takes a customer to pay its accounts.

adidas' Receivables Turnover was 6.8.

$$\text{Average Collection Period} = \frac{365}{6.8} = 53.7 \text{ days}$$



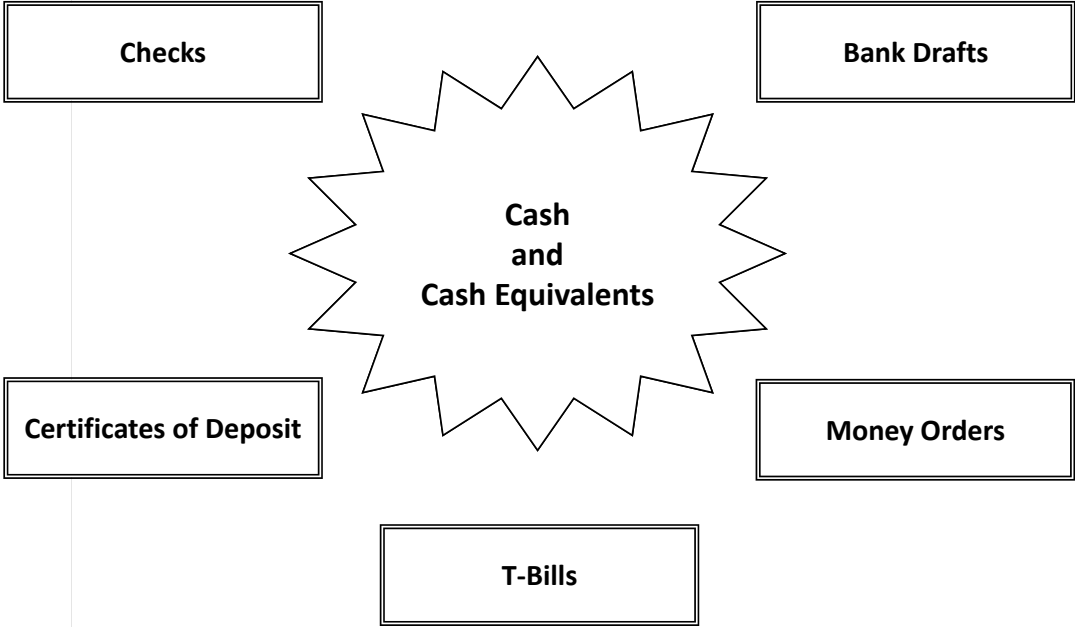
## Focus on Cash Flows



## Reporting and Safeguarding Cash



# Cash and Cash Equivalents

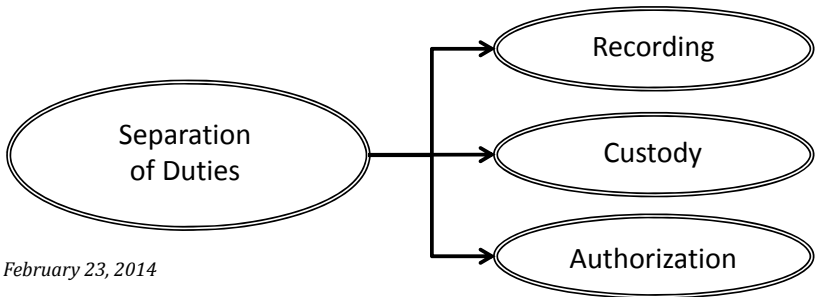


# Internal Control of Cash

Internal control refers to policies and procedures designed to:

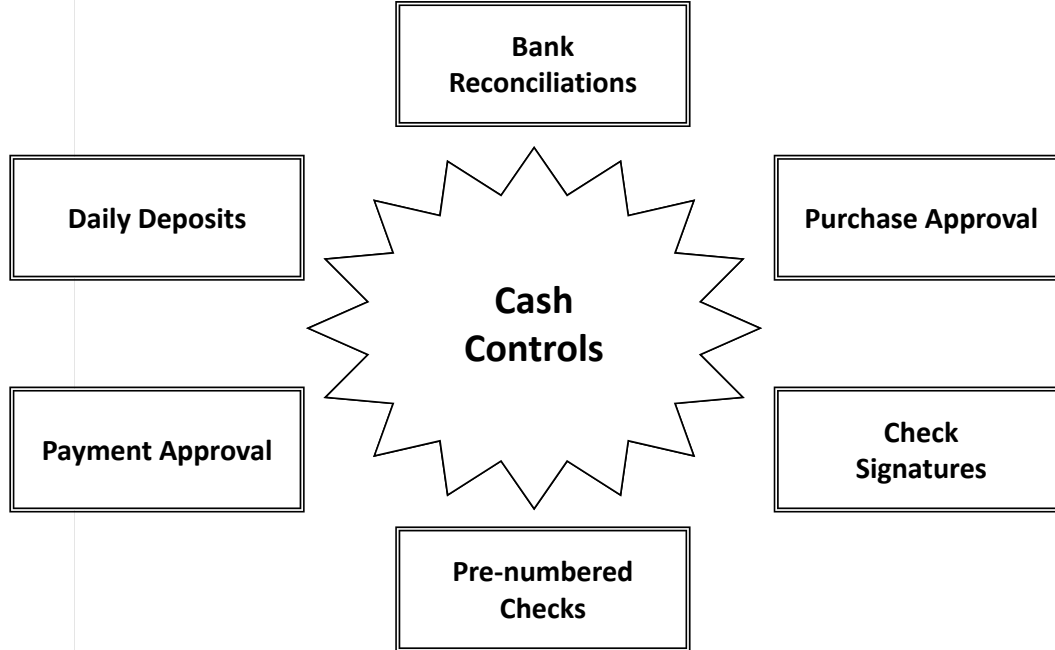


**Cash** is the asset most susceptible to theft and fraud.





## Internal Control of Cash



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## Bank Reconciliation (1)

A bank reconciliation is the process of comparing (reconciling) the ending cash balance in the company's records and the ending balance reported by the bank on the monthly bank statement.

- It is an important part of internal control.
  - Need for calculating a true cash balance
- Two "sections" to be reconciled
  - balance per bank
  - balance per books
- If there are any mistakes or transactions that have not been recorded in the company's books, adjusting journal entries will be needed.
  - Book errors: These are numerical errors made by either the company or the bank. The most common is transposition of numbers.

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## Bank Reconciliation (2)

### Possible Difference between What You and Your Bank Know

<i>Your bank may not know about . . .</i>	<i>You may not know about . . .</i>
1. Errors made by the bank 2. Time lags a. Deposits that you made recently b. Checks that you wrote recently	3. Interest the bank has put into your account 4. Service charges taken out of your account 5. Customer checks you deposited but that bounced 6. Errors made by you

#### Adjustments to BANK balance

- **Deposit in transit:** The deposit that has not been processed by the bank as of the bank statement date, usually because it was made at or near the end of the month.
- **Outstanding check:** A check that has been written and deducted from a company's cash account but have not cleared by the bank as of the bank statement date.

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## Bank Reconciliation (3)

#### Adjustments to BOOK balance

- **Bank credits:** These are additions made by the bank to a company's account before they are recorded by the company. The most common source is **interest paid by the bank** on the account balance.
- **Bank debits:** These are deductions made by the bank that have not yet been recorded by the company. The most common are monthly service charges, NSF checks, and bank transfers out of the account.
  - **NSF (Non-sufficient-fund) check:** A check that is not honored by a bank because of insufficient cash in the check writer's account.
  - **Bank Service Charge:** The bank automatically reduces the depositor's account balance for monthly fee for servicing an account.

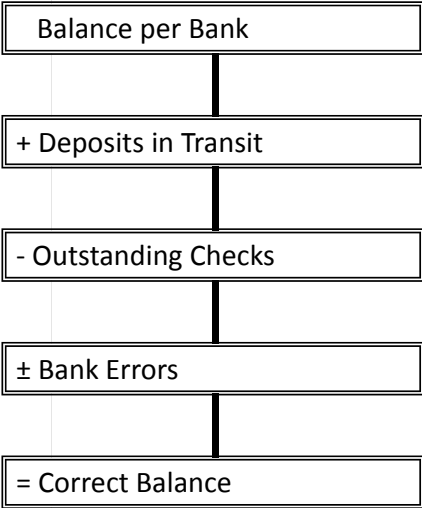
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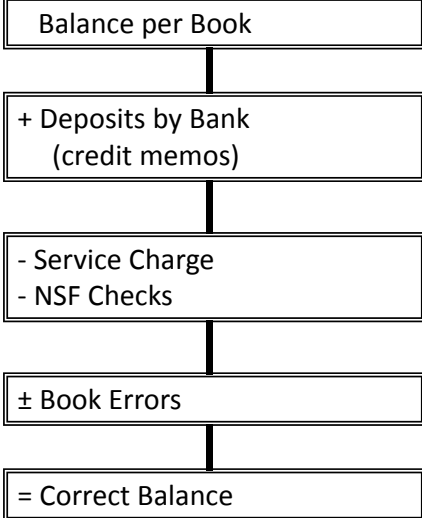


# Bank Reconciliation (4)

Explains the difference between **cash reported on bank statement** and **cash balance on company's books** and provides information for reconciling journal entries.



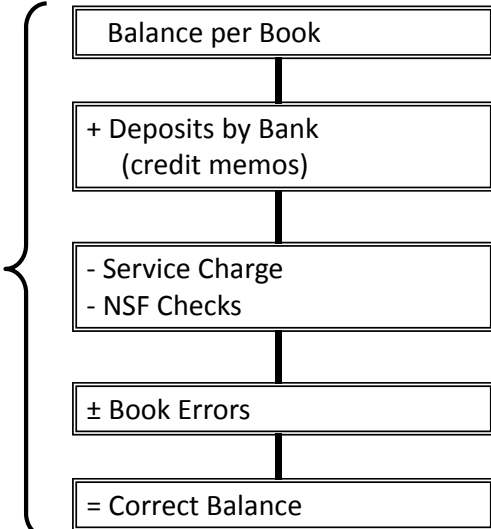
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# Bank Reconciliation (5)

Explains the difference between cash reported on bank statement and cash balance on company's books and provides information for reconciling journal entries.

All reconciling items on the book side require an adjusting entry to the cash account.



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## Bank Reconciliation (6)

Prepare a July 31 bank reconciliation statement and the resulting journal entries for the Simmons Company. The July 31 bank statement indicated a cash balance of €9,610, while the cash ledger account on that date shows a balance of €7,430.

Additional information necessary for the reconciliation is as follows.

- Outstanding checks totaled €2,417.
- A €500 check mailed to the bank for deposit had not reached the bank at the statement date.
- The bank returned a customer's NSF check for €225 received as payment of an account receivable.
- The bank statement showed €30 interest earned on the bank balance for the month of July.
- Check 781 for supplies cleared the bank for €268 but was erroneously recorded in our books as €240.
- A €486 deposit by Acme Company was erroneously credited to our account by the bank.

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## Bank Reconciliation (7)

Ending <b>BANK</b> balance, July 31		€	9,610
Additions:			
Deposit in transit			500
Deductions:			
Bank error	€	486	
Outstanding checks	2,417		2,903
			2,903
<b>Correct cash balance</b>		<b>€</b>	<b><u>7,207</u></b>
Ending <b>BOOK</b> balance, July 31		€	7,430
Additions:			
Interest			30
Deductions:			
Recording error	€	28	
NSF check	225		253
			253
<b>Correct cash balance</b>		<b>€</b>	<b><u>7,207</u></b>

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## Bank Reconciliation (8)

Based on the bank reconciliation,  
these are the entries needed to **adjust the Cash account**.

GENERAL JOURNAL				
Date		Description	Debit	Credit
Jul	31	Cash (+A)	30	
		Interest Revenue (+R, +SE)		30
		To record interest earned on checking account		
	31	Supplies Inventory (+A)	28	
		Accounts Receivable (+A)	225	
		Cash (-A)		253
		To correct bookkeeping error and adjust for NSF check		



## End of Chapter 6

