**CHAPTER 6**

**Answers to EOC Questions, Mini-Exercises, Multiple Choice Questions,**

**and Assigned Exercises and Problems.**

ANSWERS TO QUESTIONS

1. The difference between sales revenue and net sales includes the amount of goods returned by customers because the goods were either unsatisfactory or not desired, sales discounts given to business customers, and credit card fees charged by credit card companies (also refer to the answers given below to questions 3, 4 and 5).

2. Gross profit or gross margin on sales is the difference between net sales and cost of goods sold. For example, assuming sales of $100,000, and cost of goods sold of $60,000, the gross profit on sales would be $40,000.

3. A credit card discount is the fee charged by the credit card company for services. When a company deposits its credit card receipts in the bank, it only receives credit for the sales amount less the discount. The credit card discount account either decreases net sales (it is a contra revenue) or increases selling expense.

4. A sales discount is a discount given to customers for payment of accounts within a specified short period of time. Sales discounts arise only when goods are sold on credit and the seller extends credit terms that provide for a cash discount. For example, the credit terms may be 1/10, n/30. These terms mean that if the customer pays within 10 days, 1% can be deducted from the invoice price of the goods. Alternatively, if payment is not made within the 10-day period, no discount is permitted and the total invoice amount is due within 30 days from the purchase, after which the debt is past due. To illustrate, assume a $1,000 sale with these terms. If the customer paid within 10 days, $990 would have been paid. Thus, a sales discount of $10 was granted for early payment.

5. A sales allowance is an amount allowed to a customer for unsatisfactory merchandise or for an overcharge in the sales price. A sales allowance reduces the amount the customer must pay, or if already paid, a cash refund is required. Sales allowances may occur whether the sale was for cash or credit. In contrast, a sales discount is a cash discount given to a customer who has bought on credit, with payment made within the specified period of time. (Refer to explanation of sales discount in Question 4, above.)

6. An account receivable is an amount owed to the business on open account by a trade customer for merchandise or services purchased. In contrast, a note receivable is a short-term obligation owed to the company based on a formal written document.

7. In conformity with the expense matching principle, the allowance method records bad debt expense in the same period in which the credit was granted and the sale was made.

8. Using the allowance method, bad debt expense is recognized in the period in which the sale related to the uncollectible account was recorded.

9. The write-off of bad debts using the allowance method decreases the asset accounts receivable and the contra-asset allowance for doubtful accounts by the same amount. As a consequence, (a) net income is unaffected and (b) accounts receivable, net, is unaffected.

10. An increase in the receivables turnover ratio generally indicates faster collection of receivables. A higher receivables turnover ratio reflects an increase in the number of times average trade receivables were recorded and collected during the period.

11. Cash includes money and any instrument, such as a check, money order, or bank draft, which banks normally will accept for deposit and immediate credit to the depositor’s account. Cash equivalents are short-term investments with original maturities of three months or less that are readily convertible to cash, and whose value is unlikely to change (e.g., bank certificates of deposit and treasury bills).

12. The primary characteristics of an internal control system for cash are: (a) separation of the functions of cash receiving from cash payments, (b) separation of accounting for cash receiving and cash paying, (c) separation of the physical handling of cash from the accounting function, (d) deposit all cash receipts daily and make all cash payments by check, (e) require separate approval of all checks and electronic funds transfers, and (f) require monthly reconciliation of bank accounts.

13. Cash-handling and cash-recording activities should be separated to remove the opportunity for theft of cash and a cover-up by altering the records. This separation is accomplished best by assigning the responsibility for cash handling to individuals other than those who have the responsibility for record-keeping. In fact, it usually is desirable that these two functions be performed in different departments of the business.

14. The purposes of a bank reconciliation are (a) to determine the “true” cash balance and (b) to provide data to adjust the Cash account to that balance. A bank reconciliation involves reconciling the balance in the Cash account at the end of the period with the balance shown on the bank statement (which is not the “true” cash balance) at the end of that same period. Seldom will these two balances be identical because of such items as deposits in transit; that is, deposits that have been made by the company but not yet entered on the bank statement. Another cause of the difference is outstanding checks, that is, checks that have been written and recorded in the accounts of the company that have not cleared the bank (and thus have not been deducted from the bank's balance). Usually the reconciliation of the two balances, per books against per bank, requires recording of one or more items that are reflected on the bank statement but have not been recorded in the accounting records of the company. An example is the usual bank service charge.

15. The **total** amount of cash that should be reported on the balance sheet is the sum of (a) the true cash balances in all checking accounts (verified by a bank reconciliation of each checking account), (b) cash held in all “cash on hand” (or “petty cash”) funds, and (c) any cash physically on hand (any cash not transferred to a bank for deposit—usually cash held for change purposes).

16. (Chapter Supplement) Under the gross method of recording sales discounts, the amount of sales discount taken is recorded at the time the collection of the account is recorded.

ANSWERS TO MULTIPLE CHOICE

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 1. b) | 1. c) | 1. b) | 1. d) | 1. c) |
| 1. c) | 1. d) | 1. b) | 1. d) | 1. c) |

**MINI-EXERCISES**

**M6–1.**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Transaction |  | Point A |  | Point B |
| *(a)* Sale of inventory to a business customer on open account | x | Shipment |  | Collection of account |
| *(b)* Computer sold by mail order company on a credit card | x | Shipment |  | Delivery |
| *(c)* Airline tickets sold by an airline on a credit card |  | Point of sale | x | Completion of flight |

**M6–2.**

If the buyer pays within the discount period, the income statement will report $9,405 as net sales ($9,500 x 0.99).

**M6–3.**

|  |  |
| --- | --- |
| Credit card sales (R) | $9,400.00 |
| Less: Credit card discount (XR) | 282.00 |
| Net credit card sales | $9,118.00 |
|  |  |
| Sales on account (R) | $12,000.00 |
| Less: Sales returns (XR) | 650.00 |
|  | 11,350.00 |
| Less: Sales discounts (1/2 x $11,350 x 2%) (XR) | 113.50 |
| Net sales on account | 11,236.50 |
| Net sales (reported on income statement) | $20,354.50 |

**M6–4.**

(a) Allowance for doubtful accounts (–XA, +A) 14,500

Accounts receivable (–A) 14,500

To write off specific bad debts.

(b) Bad debt expense (+E, –SE) 16,000

Allowance for doubtful accounts (+XA, –A) 16,000

To record estimated bad debt expense.

**M6–5.**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Assets | Liabilities | Stockholders’ Equity |
| (a) | Allowance for doubtful accounts –15,000 |  | Bad debt expense –15,000 |
| (b) | Allowance for doubtful accounts +9,500  Accounts receivable –9,500 |  |  |

**M6–6.**

|  |  |  |
| --- | --- | --- |
| + | (*a*) | Granted credit with shorter payment deadlines. |
| + | *(b)* | Increased effectiveness of collection methods. |
| – | (*c*) | Granted credit to less creditworthy customers. |

**M6–7.**

|  |  |  |
| --- | --- | --- |
| Reconciling Item | Company’s Books | Bank Statement |
| *(a)* Outstanding checks |  | – |
| *(b)* Bank service charge | – |  |
| *(c)* Deposit in transit |  | + |

**M6–8. (Supplement)**

A $6,000 credit sale with terms, 3/10, n/30, should be recorded as follows:

Accounts receivable (+A) 6,000

Sales revenue (+R, +SE) 6,000

This entry records the sale at the gross amount. If the customer does pay within the discount period, only $5,820 must be paid, in which case the entry for payment would be as follows:

Cash (+A) 5,820

Sales discounts (+XR, –R, –SE) 180

Accounts receivable (–A) 6,000

**EXERCISES**

**E6–3.**

Sales revenue ($5,500 + $400 + $9,000) $14,900

Less: Sales returns and allowances (1/10 x $9,000 from D) 900

Less: Sales discounts (9/10 x $9,000 from D x 3%) 243

Less: Credit card discounts ($400 from C x 2%) 8

Net sales $13,749

**E6–6.**

(a) Bad debt expense (+E, –SE) ($1,300,000 x 0.01) 13,000

Allowance for doubtful accounts (+XA, –A) 13,000

To record estimated bad debt expense.

(b) Allowance for doubtful accounts (–XA, +A) 4,000

Accounts receivable (–A) 4,000

To write off a specific bad debt.

**E6–11.**

Req. 1

December 31, 2013-Adjusting entry:

Bad debt expense (+E, –SE) 4,180

Allowance for doubtful accounts (+XA, –A) 4,180

To adjust for estimated bad debt expense for 2013 computed as follows:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Aged accounts receivable | |  | Estimated percentage uncollectible |  | Estimated amount uncollectible |
| Not yet due | $50,000 | x | 3% | = | $ 1,500 |
| Up to 180 days past due | 14,000 | x | 12% | = | 1,680 |
| Over 180 days past due | 4,000 | x | 30% | = | 1,200 |
| Estimated balance in Allowance for Doubtful Accounts | | | | | 4,380 |
| Current balance in Allowance for Doubtful Accounts | | | | | 200 |
| Bad Debt Expense for the year | | | | | $4,180 |

Req. 2

Balance sheet:

Accounts receivable ($50,000 + $14,000 + $4,000) $68,000

Less allowance for doubtful accounts 4,380

Accounts receivable, net of allowance for

doubtful accounts $63,620

**E6–13.**

1. Bad debt expense (+E, –SE) 213

Allowance for doubtful accounts (+XA, –A) 213

To record estimated bad debt expense.

Allowance for doubtful accounts (–XA, +A) 201

Accounts receivable (–A) 201

To write off specific bad debts.

2. It would have no effect because the asset “Accounts receivable” and contra-asset “Allowance for doubtful accounts” would both decline by Euro 10 million. Neither “Receivables, net” nor “Net income” would be affected.

**E6–15.**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Req. 1 **Allowance for Doubtful Accounts** | | | | |
|  |  | 375 | Beg. balance |
| Write-offs | 56 | 14 | Bad debt exp. |
|  |  | 333 | End. balance |

Beg. Balance + Bad debt exp. – Write-offs = End. Balance

Beg. Balance + Bad debt exp. – End. Balance = Write-offs

375 + 14 – 333 = 56

Bad debt expense increases (is credited to) the allowance. Since we are given the beginning and ending balances in the allowance, we can solve for write-offs, which decrease (are debited to) the allowance.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Req. 2 **Accounts Receivable (Gross)** | | | | |
| Beg. balance\* | 13,389 | 56 | Write-offs |
| Net sales | 69,943 | 67,956 | Cash collections |
| End. balance \*\* | 15,320 |  |  |

\* 13,014 + 375

\*\* 14,987 + 333

Beg. balance + Net sales – Write-offs – Cash collections = End. Balance

Beg. balance + Net sales – Write-offs – End. Balance = Cash collections

13,389 + 69,943 – 56 – 15,320 = 67,956

Accounts receivable gross is increased by recording credit sales and decreased by recording cash collections and write-offs of bad debts. Thus, we can solve for cash collections as the missing value.

**E6–18.**

Req. 1

Dec. 31, 2014

Allowance for doubtful accounts (–XA, +A) 550

Accounts receivable (Toby’s Gift Shop) (–A) 550

To write off an account receivable determined to

be uncollectible.

Dec. 31, 2014

Bad debt expense (+E, –SE) 500

Allowance for doubtful accounts (+XA, –A) 500

Adjusting entry--estimated loss on uncollectible

accounts; based on credit sales ($25,000 x 2%

= $500).

Req. 2

Income statement:

Operating expenses:

Bad debt expense $500

Balance sheet:

*Current assets*

Accounts receivable ($3,500 + $25,000

- $18,000 - $550) $9,950

Less: Allowance for doubtful accounts

($300 - $550 + $500) 250 $9,700

Req. 3

The 2% rate on credit sales appears reasonable because it approximates the amount of receivables written off ($550) during the year. However, if the uncollectible account receivable written off during 2014 is not indicative of average uncollectibles written off over a period of time, the 2% rate may not be appropriate. There is not sufficient historical data to make a definitive decision.

**E6–20.**

Req. 1

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Receivables turnover | = | Net Sales | = | $62,071,000 | = | 9.5722 times |
|  |  | Average Net Trade Accounts Receivable |  | $6,484,500\* |  |  |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Average days sales | = | 365 | = | 365 | = | 38.13 days |
| in receivables |  | Receivables Turnover |  | 9.5722 |  |  |

\* ($6,493,000 + $6,476,000) ÷ 2

Req. 2

The receivables turnover ratio reflects how many times average trade receivables were recorded and collected during the period. The average days sales in receivables indicates the average time it takes a customer to pay its account.

**CASES AND PROJECTS**

**CP6–3.**

1.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Current year** | | | | **American Eagle Outfitters** | | | | | **Urban Outfitters** | | | | |
| Receivables | = | Net Sales |  |  | $3,159,818 | = | 82.0 |  |  | $2,473,801 | = | 67.6 |  |
| Turnover Ratio |  | Average Net Trade Accounts Receivable |  |  | 38,516\*  \*($36,721 + 40,310) ÷ 2 | | |  |  | 36,588  \*($36,673 + 36,502) ÷ 2 | | | |

2. American Eagle Outfitters has a higher ratio than Urban Outfitters because American Eagle and Urban Outfitters sell to different classes of customers. American Eagle sells its products almost exclusively to retail and online customers, who are likely to pay with cash or credit card. Urban Outfitters sells its product not only to retail and online customers, but also to wholesale customers, who are likely to purchase merchandise on credit. As seen in Note 2 of the financial statements, the accounts receivable on Urban Outfitter’s balance sheet relate primarily to amounts owed from wholesale customers and third-party credit card vendors. The accounts receivable on American Eagle’s balance sheet relate primarily to amounts owed from the company’s 21 franchise stores.

3.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Industry  Average** | **American Eagle Outfitters** | **Urban Outfitters** |
| Receivables Turnover = | 97.5 | 82.0 | 67.6 |

Both companies have a lower receivables turnover ratio than the industry average. For American Eagle Outfitters this lower ratio likely reflects the company’s recent decision to expand internationally through franchises, who owe the company approximately 400% more in receivables than last year. For Urban Outfitters, this lower ratio likely reflects the company’s wholesale operations, as discussed in requirement 2.

## FINANCIAL REPORTING AND ANALYSIS CASES

**CP6–4.**

1. Yes. Given that only one three-year project is worked on at a time, the completed contract method would result in no revenue being recognized for two out of every three years, and all of the revenue from each project being recognized during the third. If the same amount of work was completed each year, the percentage of completion method would result in an approximately equal amount of revenue each period.

2. If the company regularly started and completed a larger constant number of equal sized projects each reporting period, the size of any difference between revenues reported under the two methods would decline.

3. Under generally accepted accounting principles, the appropriate method would be determined by whether the costs to complete can be accurately assessed. If they can be accurately estimated, the percentage of completion method is appropriate. If not, the completed contract method should be used. However, managers generally prefer to report the smoother earnings pattern conveyed by the percentage of completion method because smoother earnings are generally thought to convey lower risk to investors.