


Chapter 7, Module 4

Slide 1

Chapter 7 Module 4

AMIS 211
Introduction to Financial Accounting

Professor Marc Smith

 **FISHER**
COLLEGE OF BUSINESS

Hi everyone. Welcome back.

Now that we have gone through the basic transactions that impact the Accounts Receivable and the Allowance for Doubtful Accounts, let's take a look at an Example and see if we can go ahead and make the entries for ourselves.

And, the Example I want to look at comes from the Web site problems, so make sure to have that in front of you.

And, let's look at Example #2.

Let's just read it together before we get started.

Here is what it says:

“The following transactions relate to Betty DiRose Inc.” And you can see that there are five (5) transactions: January 4th through March 8th 2004 through 2005. And, the Requirements are: “For each transaction, first make the Journal Entry to record it. And then, secondly, for each transaction, indicate the effect it has on Net Income, the Income Statement; our Net Realizable Value (NRV), the Balance Sheet, and our cash flows, the Statement of Cash Flows.”

So, how does each transaction effect the major financial statements?

Let’s go ahead and get started.

Let’s move to the next slide.

Slide 2

Chapter 7 Module 4: Example #2

This is recording the credit sale

General Journal			
Date	Account Titles	Debit	Credit
1/4/04	Accounts Receivable	6,500	
	Sales Revenue		6,500

Net Income	Increase
Net Realizable Value	Increase
Cash Flows	No Effect

And, let’s start with the first transaction: January the 4th.

“Betty made a credit sale to M.T. Glass—a customer—in the amount of \$2,500 and a credit sale to Sandy Beach—a customer—in the amount of \$4,000.”

So, we have to record the making of a credit sale.

This is one we should be able to do without a lot of difficulty.

To record a credit sale:

You debit Accounts Receivable and credit Sales Revenue to reflect the fact that: we have earned revenue by making a sale but we have not collected the cash yet. So, we have an Account Receivable.

So, the next question is:

How does this credit sale impact our three financial statement items—Net Income, NRV, and cash flows?

Net Income is increased.

We have Sales Revenue. The revenue increases the Net Income on the Income Statement.

The Net Realizable Value (NRV)—which you should remember is: your Accounts Receivable minus (-) your Allowance for Doubtful Accounts.

The NRV is also increased.

You have increased your Accounts Receivable. You have increased the first side of the subtraction. So, we have an increase to Accounts Receivable causing an increase to the Net Realizable Value.

Notice: the credit sale increases Revenue on the Income Statement but does not affect Cash. No cash has been received. No cash flow impact.

This is the distinction between Accrual Accounting—the Income Statement—and Cash Accounting—the Statement of Cash Flows.

Okay! That one kind of gets us off and rolling. We should be pretty comfortable with that. We have seen dealing with credit sales before.

Let's go to the next slide.

Slide 3

Chapter 7 Module 4: Example #2**This is recording the collection of a credit sale**

General Journal			
Date	Account Titles	Debit	Credit
3/19/04	Cash	4,000	
	Accounts Receivable		4,000

Net Income**No Effect****Net Realizable Value****Decrease****Cash Flows****Increase (Operating)**

And, let's look at the next transaction.

Sandy Beach—the customer that we had a credit sale of \$4,000 to; she made a payment. She sent in the cash that she owed us on March 19th.

We have to record a collection of a credit sale.

This is another entry that we should be able to do without too much difficulty.

We know that when a customer pays their Account Receivable balance, you debit Cash and you credit Accounts Receivable.

So, you debit Cash and credit Receivables for what was collected.

How does that impact our financial statement elements?

Remember: with the collection of an Account Receivable, there is no effect on Net Income.

How does it affect NRV?

It decreases the NRV.

How come?

Because: the Accounts Receivable is being decreased.

Hey, look at that transaction:

There is no overall effect on Assets. We have one Asset: Cash going up; the other Asset: Accounts Receivable going down.

However, the NRV is the Accounts Receivable minus (-) the Allowance.

When the Accounts Receivables decrease, so does the Net Realizable Value (NRV).

So, for the collection of an Accounts Receivable: there is no effect on the Income Statement. There are no Revenues or Expenses in that Journal Entry.

It does, however, decrease the Net Realizable Value (NRV) because it decreases Accounts Receivable.

It obviously affects cash flows. We are getting cash.

Which category of cash flows would this be?

You tell me.

It would be Operating, right? It is an Operating cash inflow—cash collected from customers.

Okay!

Let's go to the next slide.

Slide 4

Chapter 7 Module 4: Example #2

This is a write-off

General Journal			
Date	Account Titles	Debit	Credit
9/27/04	Allowance for Doubtful Accounts	2,500	
	Accounts Receivable		2,500

Net Income	No Effect
Net Realizable Value	No Effect
Cash Flows	No Effect

And, let's look at the next transaction.

September 27th:

Remember M.T. Glass—the customer we made a sale to way back on January 4th?

Well, after we have tried to collect; we have made a very concerted effort. We have done all of the different steps to try to collect our cash. After a concerted effort to collect, we have finally decided M.T. Glass was not going to pay us and we wrote off that Account Receivable.

So, we have to record a write-off.

To record a write-off, the entry that we will make: we will debit the Allowance for Doubtful Accounts; credit Accounts Receivable.

How will this impact our financial statement elements?

Net Income: There is no effect. There are no Revenues and there are no Expenses in that Journal Entry. A write-off does not affect bad debt expense. Hence, there is no effect on Net Income.

Here is the counter-intuitive one:

How does the write-off affect the Net Realizable Value (NRV)—the Accounts Receivable minus (-) the Allowance?

It doesn't!

There is no effect of a write-off on the NRV. We are decreasing both sides of the subtraction—decreasing both the Receivables and the Allowance by the same amount.

There is no effect on the difference—the Net Realizable Value (NRV).

You can look at that entry and see that there is no cash involved. Hence, there is no effect on cash flows.

All right!

Let's go to the next slide.

Slide 5

Chapter 7 Module 4: Example #2**This is recording the bad debt expense estimate**

General Journal			
Date	Account Titles	Debit	Credit
12/31/04	Bad Debt Expense	2,460	
	Allowance for Doubtful Accounts		2,460

Net Income	Decrease
Net Realizable Value	Decrease
Cash Flows	No Effect

And, let's look at the next transaction.

December 31st:

We have to estimate our bad debt expense.

And, we estimate that it will be 1% of the year's credit sales of \$246,000.

So, our bad debt expense—1% of \$246,000—is simply 2,460 bucks (\$2,460.00).

To record the bad debt expense estimate: debit: Bad Debt Expense; credit: Allowance for Doubtful Accounts 1% of the credit sales.

How will the estimate of bad debt expense affect our financial statement items?

Bad debt expense is an Expense. So, Expenses are going up causing Net Income to go down.

We are also increasing the Allowance for Doubtful Accounts—a credit to that account increases it. When the Allowance goes up, the NRV—the Net Realizable Value—also, goes down.

Look at the Journal Entry.

Do you see cash there? Is there any cash involved in the bad debt expense estimate?

No!

Hence, there is no effect on your cash flows.

All right!

Let's go to the next slide and let's look at the last transaction.

Slide 6

<i>Chapter 7 Module 4: Example #2</i>			
This is a recovery			
General Journal			
Date	Account Titles	Debit	Credit
3/8/05	Cash	2,500	
	Allowance for Doubtful Accounts		2,500
Net Income		No Effect	
Net Realizable Value		Decrease	
Cash Flows		Increase (Operating)	

Remember: M.T. Glass? We made a credit sale to him on January 4th of 2004. Then, we tried and we tried and we tried to collect our cash. And, we

finally decided on September 27th of 2004 to write him off—that he was not going to pay us.

Here it is: March 8th of 2005 and M.T. Glass is coming up with the amount he owed. He sent in the payment of the amount that he owed us.

We have what is called a Recovery.

So, we have to record a Recovery.

And, to record a Recovery, we debit Cash for what we receive and we credit the Allowance for Doubtful Accounts.

To record a Recovery: debit to Cash; credit to the Allowance.

How is this going to impact our financial statement items?

Net Income: There is no effect. Neither of those accounts are Revenues or Expenses. Hence, there is no effect on Net Income.

However, the NRV—the Accounts Receivable minus (-) the Allowance: the Allowance is going up here. That causes a decrease in the Net Realizable Value (NRV).

Increase the Allowance; decrease the NRV.

In addition, you look at the entry: there is cash so we have impacted our cash flows.

Cash Received: that is a cash inflow that is considered Operating: Cash Collected from Customers.

This is a really good example.

You want to be comfortable with 1) the basic entries to record these transactions. Much more important: 2) how do the different transactions relating to Accounts Receivable—and we have hit them all—making a sale, collecting the cash, a write-off, bad debt expense estimate, and a recovery; how do those different transactions effect the major financial statements?

Please go to the next slide with me.

Slide 7

Chapter 7 Module 4: Allowance Dbt Accts.

<i>Allowance for Doubtful Accounts</i>	
<i>Beginning</i>	<i>Balance</i>
<i>Write-offs</i>	<i>Recoveries</i>
	<i>Bad debt expense</i>
	<i>Ending Balance</i>

NOTE: **The allowance for doubtful accounts can have a beginning balance on either the debit or credit side before the year-end adjustment for bad debt expense. The ending balance will always be on the credit side of the t-account.**

And, there is our T-Account—the Allowance for Doubtful Accounts.

Let's put in what we know affects the Allowance.

The Allowance is increased by bad debt expense. The Allowance is decreased by our write-offs. And, it is increased by Recoveries.

The Allowance is a Contra-Asset meaning: the Ending Balance is going to be on the credit side of the T-Account.

However, we have something that could be a little tricky.

The Beginning Balance can be on either side of the T-Account. It can either be a Beginning debit or a Beginning credit.

And, we need to understand why.

Why is it that the Allowance for Doubtful Accounts—a Contra-Asset—can have a Beginning balance that is either a debit or credit before the adjustment for bad debt expense?

Note that: after the bad debt adjustment is made at year-end, the Ending Balance is always on the credit side.

But, prior to that; it is entirely possible for the Beginning balance to be either a debit or a credit.

Now, please go to the next slide with me.

Slide 8

Chapter 7 Module 4: Allowance Dbt Accts.

<i>Allowance for Doubtful Accounts</i>	
<i>Beginning</i>	<i>Balance</i>
<i>Write-offs</i>	<i>Recoveries</i>
	<i>Bad debt expense</i>
	<i>Ending Balance</i>

NOTE: **A debit side balance indicates:**

more accounts receivable have been written-off than we expected (i.e., we have under-estimated bad debt expense)

And, there is our T-Account again.

If the T-Account—if the Allowance for Doubtful Accounts—has a debit side balance before the bad debt expense estimate; what that means is: the write-off side is larger than the bad debt expense side.

Because: note one thing that is important here.

Note that your Recoveries are rare. So, those usually have minimal effect on the Allowance.

We should also note that: the Ending Balance is done after we make the adjustment for bad debt expense.

So, the two key items that really affect this account: 1) the bad debt expense on the credit side; and 2) the write-offs on the debit side.

How do those things differ?

Bad debt expense is an estimate. Write-offs are actual amounts.

To have a balance on the debit side, the write-offs are higher. That means: the actual write-offs were larger than what we thought they were going to be. We underestimated our bad debt expense.

Write-offs exceeded the estimate. Hence, we have a debit side balance.

Please go to the next slide with me.

Slide 9

*Chapter 7 Module 4: Allowance Dbt Accts.**Allowance for Doubtful Accounts*

<i>Beginning</i>	<i>Balance</i>
<i>Write-offs</i>	<i>Recoveries</i>
	<i>Bad debt expense</i>
	<i>Ending Balance</i>

NOTE: **A credit side balance indicates:**

less accounts receivable have been written-off than we expected (i.e., we have over-estimated bad debt expense)

And, once again, let's look at our T-Account.

Let's look at the items that typically affect it.

So, let's eliminate recoveries—the effect is rare.

Let's get rid of the Ending Balance—that is done at the end; that is not done prior to the estimate.

What typically affects this account is: 1) the bad debt expense and 2) the write-offs.

If the account has a credit side balance; that means: the estimate was larger than what we actually wrote off. We over-estimated our bad debt expense.

We wrote off less than what we thought we were going to have to write-off.

And, I really think, these last two slides—they are very important to you. You really want to understand them.

If your Allowance for Doubtful Accounts has a debit side balance, the write-offs are larger than the bad debt estimate. We wrote off more than we thought we were going to. Our estimate was understated.

On the other hand, if the account has a credit-side balance, the bad debt expense was larger than the write-offs. The estimate was more than what we actually wrote off. We overestimated our write-offs.