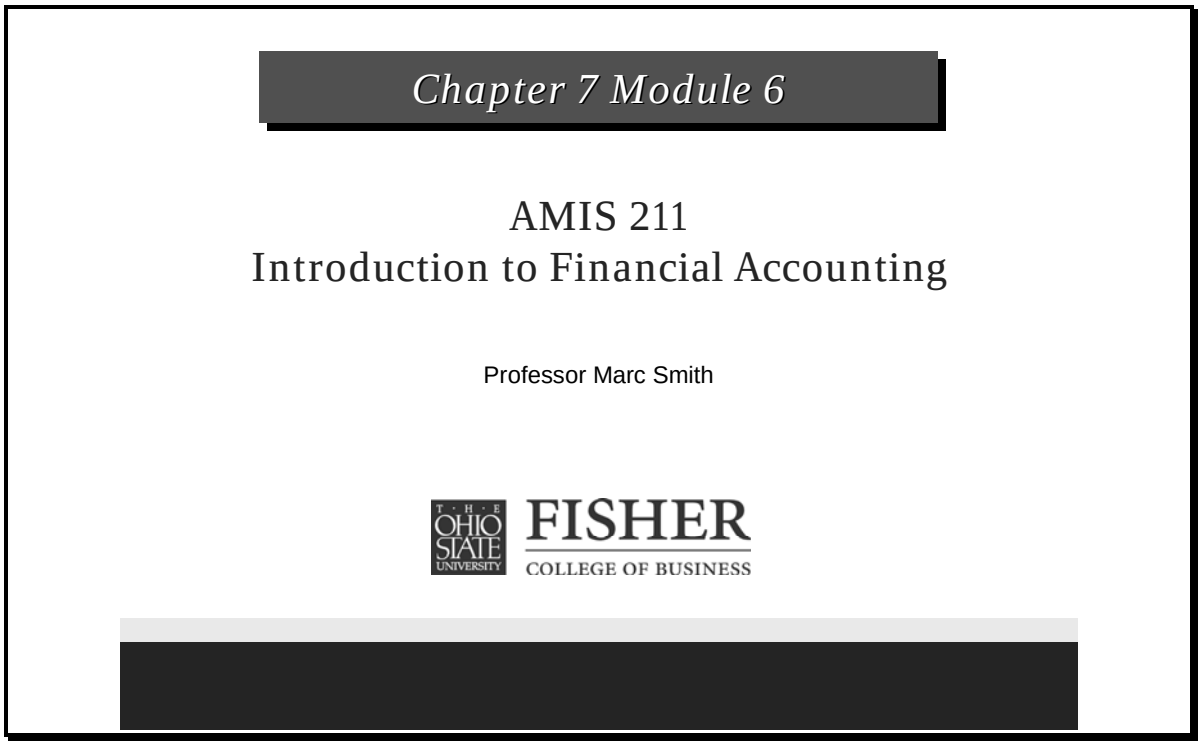
Chapter 7, Module 6

Slide 1



Hi everyone. Welcome back.

Let's see if we can put our knowledge as to how to estimate bad debts to test. And, let's try a couple of examples.

In this Module, let's work through Example #3 from the Web site problems.

And, let's just read it together before we get started.

Here is what it says:

"XYZ Company had a $250,000 balance in its Accounts Receivable on December 31st, 2002. Additionally, they had a $2,100 Credit Balance in their Allowance for Doubtful Accounts at Year-End 2002 before the Adjustment (AJE) for bad debt expense. During 2002, XYZ Company reported Credit Sales of $800,000."

Required: Part A.

"Let's go ahead and let's calculate the bad debt expense and the Net Realizable Value (NRV) of our Accounts Receivable using the Net Credit Sales Method."

And, Part A says: "Assume that we are estimating that 2% of our Net Credit Sales will be uncollectible."

Let's go ahead to the next slide and let's work the problem.

Slide 2

Chapter 7 Module 6: Example #3, Part A

Part A: ***Net Credit Sales Method***

1. Bad debt expense = 800,000 x .02
Bad debt expense = $16,000

2. Accounts Receivable
- Allowance for Doubtful Accounts
Net Realizable Value

NOTE: To determine the allowance for doubtful accounts, always use a t-account

Under the Net Credit Sales Method: we know that the bad debt expense estimate is really very straightforward.

We simply take the Net Credit Sales for the year—given as $800,000—and multiply (x) it by the percentage (%) we expect to be uncollectible—2%.

Our bad debt expense is estimated as $16,000 for the year.

So, using the Net Credit Sales Method to come up with bad debt expense is really pretty straight forward.

Requirement 2 of Part says: “After we make the adjustment (AJE) for bad debt expense, what would be the company’s Net Realizable Value (NRV)?”

Now, we do know that this is true:

The Accounts Receivable minus (-) the Allowance for Doubtful Accounts is equal to (=) our NRV (Net Realizable Value).

And, we know what the Accounts Receivable is; they tell us that in the problem.

What we DO NOT KNOW is the balance in the Allowance for Doubtful Accounts.

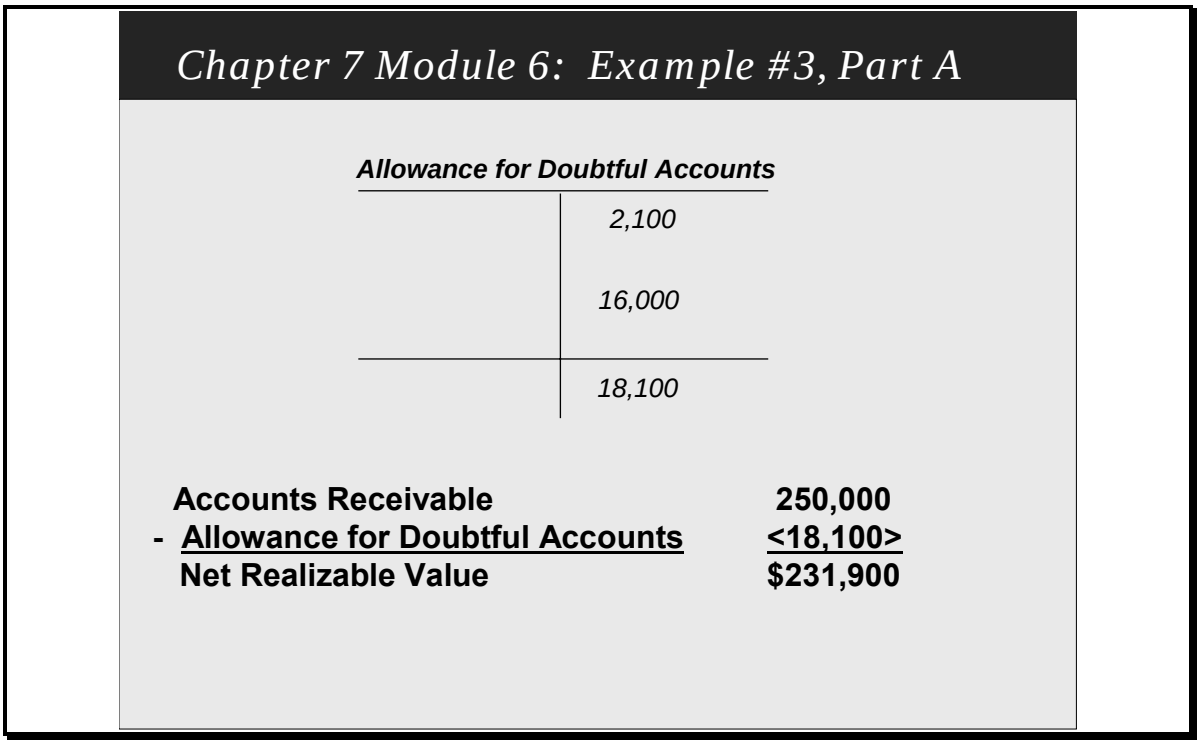
My advice to you:

Any time you are working these problems—these bad debt expense estimates—these problems—you really should have a T-Account.

The best thing you can do is set up a T-Account for the Allowance for Doubtful Accounts. Know what goes on what side of that T-Account. Plug it in there. And, BOOM! Your answer will come right out.

So, let’s go ahead to the next slide.

Slide 3



And, let's set up our T-Account.

What we know is that: the Beginning Balance in this account was a $2,100 credit balance. That is given in the problem.

We also know that: the bad debt expense estimate for the year, which increases (+) this account were $16,000.

That allows us to calculate the Ending Balance in the Allowance for Doubtful Accounts to be: $18,100.

Once we know that, we can go ahead and figure out the NRV—the Net Realizable Value.

Remember: It is Accounts Receivable minus (-) the Allowance for Doubtful Accounts.

We know, from the problem, the Accounts Receivable is $250,000.

We know—because we just calculated it here in the T-Account—the Allowance for Doubtful Account is: $18,100; giving us a Net Realizable Value (NRV) of: $231,900.

Again, I think you really just do yourself a service whenever you are dealing with estimating bad debts; you really ought to have a T-Account for the Allowance to work with. It just makes your life a lot easier.

Now, if you look at Part B of this problem:

It says: “Forget about what you just did. We are not going to use the Net Credit Sales Method. But, rather let’s assume that we estimate bad debt expense using the Aging Method.”

And, they have provided us with an Aging Schedule.

Let’s go through the same set of calculations.

Please go to the next slide with me.

Slide 4

Chapter 7 Module 6: Example #3, Part B

Part B: ***Aging Method***

Σ (Amount of receivables x %)

Age	Balance	Percentage Estimated to be Uncollectible	Amount
Current.	$150,000	2%	$ 3,000
1-30 days.	60,000	4	2,400
31-90 days.	30,000	9	2,700
Over 90 days.	10,000	20	2,000
	$250,000		$10,100

The $10,100 represents the required ending credit balance in the allowance for doubtful accounts.

Using the Aging Schedule, we know that we have to do a multiplication.

You take the amount of the Receivables in each category, multiply (x) by the percentage (%) expected uncollectible in that category. And then, for each category, you take that product and add (+) it together.

And, it is done for you right here.

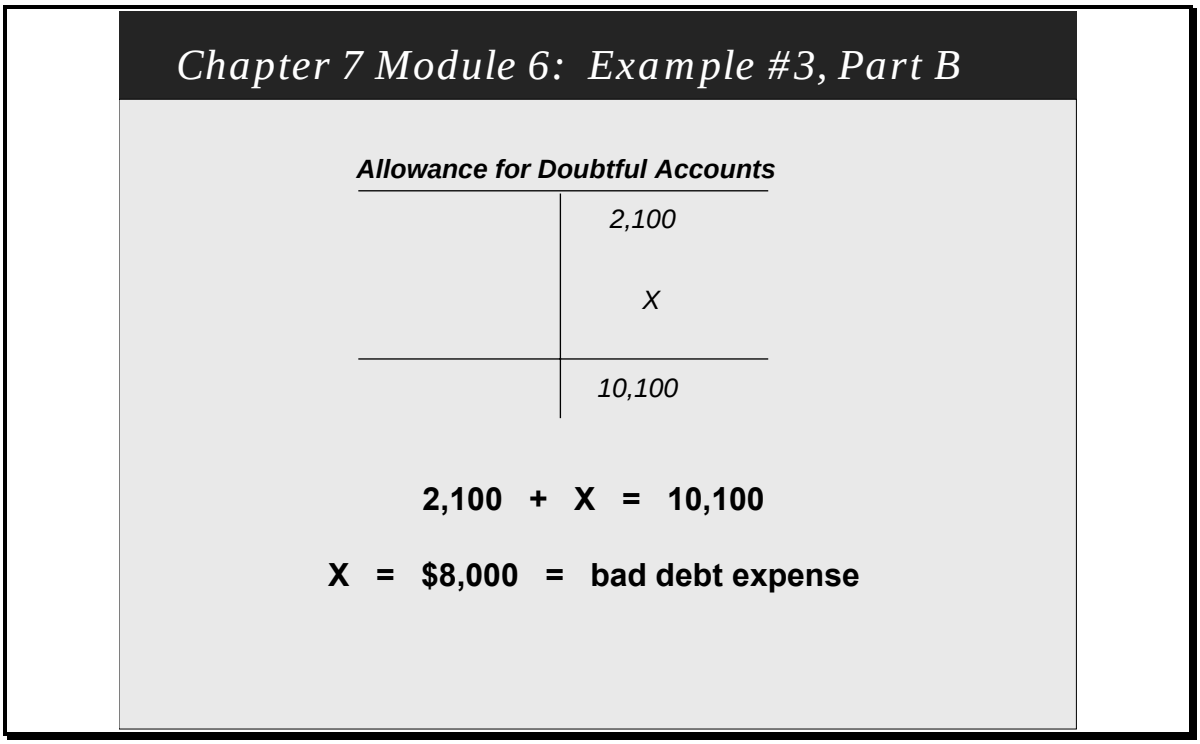
You get $10,100 as your number from the Aging Schedule.

Key point: You have to remember! The $10,100 IS NOT your bad debt expense estimate. Rather, the $10,100 represents the required Ending Credit Balance in the Allowance for Doubtful Accounts.

This is very important! Because: it is so easy to calculate that number and BOOM! Call it your bad debt expense. And, that is WRONG! It represents the Ending Credit Balance in the Allowance for Doubtful Accounts.

So, go to the next slide.

Slide 5



And, let's, again, use a T-Account. And, let's quote/unquote "force out:" the amount of bad debt expense.

Here is what we know:

The Beginning Balance is a $2,100 credit.

We know, from the Aging Schedule, that the Ending Credit Balance is $10,100.

That allows us to calculate our bad debt expense, which goes on the credit side of the T-Account. Make it "x" to now "force out," or to figure out, the bad debt expense estimate.

Set up an Algebra equation: Beginning Balance ($2,100), plus (+) the increase—the "x"—equals (=) the Ending Balance ($10,100).

Solve for "x"—your bad debt expense.

That is estimated as $8,000, using the Aging Schedule.

Now, just keep in mind: Look at this T-Account and remember those numbers.

Now, I want you to go to the next slide with me.

Slide 6

Chapter 7 Module 6: Example #3, Part B

Part B: *Aging Method*

Accounts Receivable	**250,000**
- Allowance for Doubtful Accounts	**<10,100>**
Net Realizable Value	**$239,900**

Under this Aging Method, in Requirement 2: "Calculate the Net Realizable Value (NRV)."

The NRV, as we know, is (=) Accounts Receivable minus (-) the Allowance.

And, we know the Accounts Receivable is $250,000.

How are we going to calculate the Allowance?

It is done already!

We already know the Ending Balance in the Allowance. That comes from the Aging Schedule. That is $10,100.

That allows us to calculate the NRV—the Net Realizable Value—as: $239,900.

Requirement 3 of this problem:

Let's just read it together.

Here is what it says:

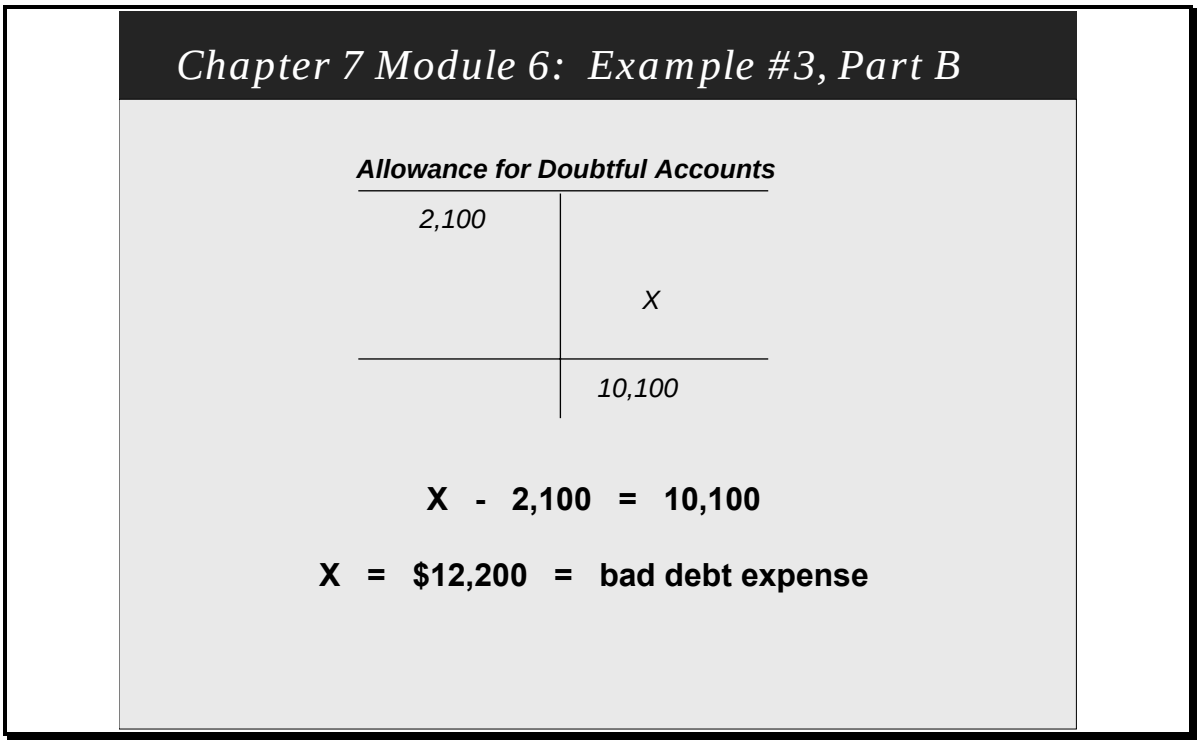
"Calculate the bad debt expense using the bad debt expense using the Aging Method…"with one change to what we did just a few moments ago.

"Assume the Beginning Balance was a $2,100 debit side balance."

How will that change our calculations?

Go to the next slide with me.

Slide 7



There is our T-Account.

What can we enter in?

We know that the Beginning Balance of $2,100 is now on the debit side of the T-Account.

We know that the Ending Balance comes from the Aging Schedule--$10,100—it is and it is an Ending Credit Balance—always!

The bad debt expense is our "x." It is always in the same place.

Force out the bad debt expense. Use a little Algebra.

But now, we set it up where the $2,100 was a decrease (-)—that is on the debit side. That decreases (-) the Allowance.

So, the "x"—the bad debt expense—minus (-) the $2,100 equals (=) the Ending $10,100. We solve for "x"—our unknown; that is the estimate of bad debt expense here. It is $12,200.

This is a real basic example. In a minute, we will look at another one that is a little more involved.

This is a basic one but it is really good because: it just gets you to use both methods and work through all of the important calculations.