ACCOUNTING FOR RECEIVABLES AND PAYABLES

11

THE NAVIGATOR ✓

- Understand *Concepts for Review* ❑
- Read *Feature Story* ❑
- Scan *Study Objectives* ❑
- Read *Preview* ❑
- Read text and answer *Before You Go On*
  p. 361 ❑ *p.* 363 ❑ *p.* 370 ❑
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- Review *Summary of Study Objectives* ❑
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CONCEPTS FOR REVIEW

Before studying this chapter, you should know or, if necessary, review:

a. How to record sales transactions. (Ch. 7, pp. 208–210)

b. Why adjusting entries are made. (Ch. 4, pp. 115–116)

c. How to compute interest. (Ch. 4, p. 125)

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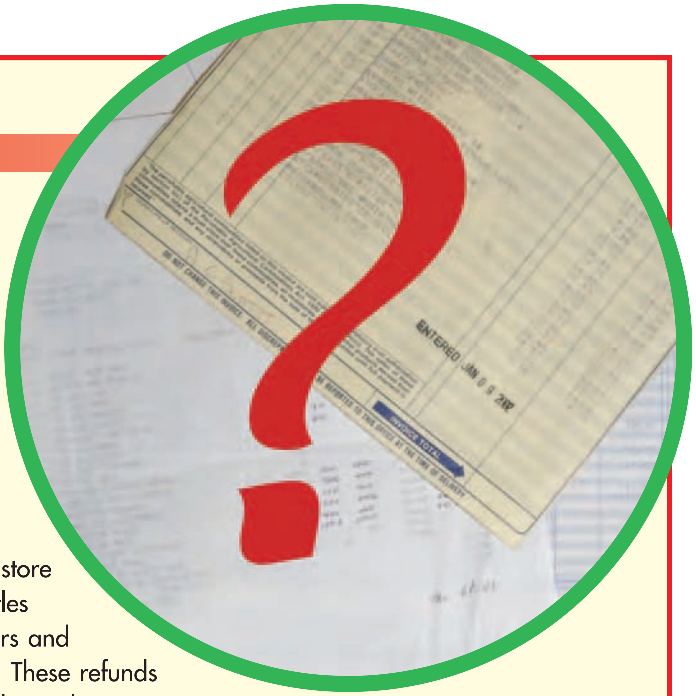
FEATURE STORY



Show Me the Money

When businesses refer to accounts receivables, it is the money that is owed to them. Accounts payables, on the other hand, represent money that businesses owe to others. So, what about deposits on beer bottles paid by customers, refunds paid to customers when the bottles are returned, deposits paid by businesses when the beer sellers deliver the cases, and the refund checks beer sellers write to businesses when they pick up the bottles? They are all part of receivables and payables.

Ralph R. Miller, president of **Inntegrated Hospitality Management Ltd.** in Canada, started in the hospitality business as a chef, became a Chartered Account in Canada (equivalent to a Certified Public Accountant in the United States), worked for **Coopers and Lybrand**, an accounting firm, and started the hospitality arm for Coopers. In the early 1990s, he also managed a full-service hotel in Calgary.

This particular hotel is unique in that it has a license to operate a liquor store on premise. The liquor store alone generates $5 million in sales per year. The refrigerator for this liquor store could store 104 pallets of beer, each pallet holding 72 cases of 24 bottles per case. Customers who purchase beer pay a deposit on the bottles, and receive a refund later when they return the bottles to a liquor store. The store also takes in bottles from noncustomers and provides refunds. These refunds are recorded in the cash registers, and money therefore is taken out of the cash registers. At the end of the day, the amount of bottles refund is noted and the bottles are put in a bottle recycling bin. The beer seller picks up the bin content periodically and issues a check to the liquor store for the amount determined by the number of bottles recycled.

From the standpoint of accounting procedures, the amounts taken from the cash registers are recorded on a daily basis, offset by the amount received by the refund checks issued by the beer seller. All was well until six employees became a little too greedy. Each of them rung up fictitious refunds on the register without the bottles and kept the cash. All six of them did this daily, so the discrepancies between cash registers paid out and beer sellers' refund checks grew until the bottle refund checks from the supplier made little resemblance to the daily paid outs recorded by the liquor store cash register. Forensic accounting done on a six-month period revealed a total fraud of more than $57,000.

Miller gathered all the evidence and brought the issue to justice. All six employees had to pay restitution, with two employees serving jail time. He quoted an age-old adage, "You watch the pennies and the dollars will take care of themselves." Just think, even a $0.10-per-bottle refund can turn into a $57,000 fraud with jail time in six months!

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STUDY OBJECTIVES

After studying this chapter, you should be able to

1. Identify the different types of receivables.
2. Explain how accounts receivable are recognized in the accounts.
3. Distinguish between the methods and bases used to value accounts receivable.
4. Describe the entries to record the disposition of accounts receivable.
5. Explain why credit policies are needed in the hospitality industry.

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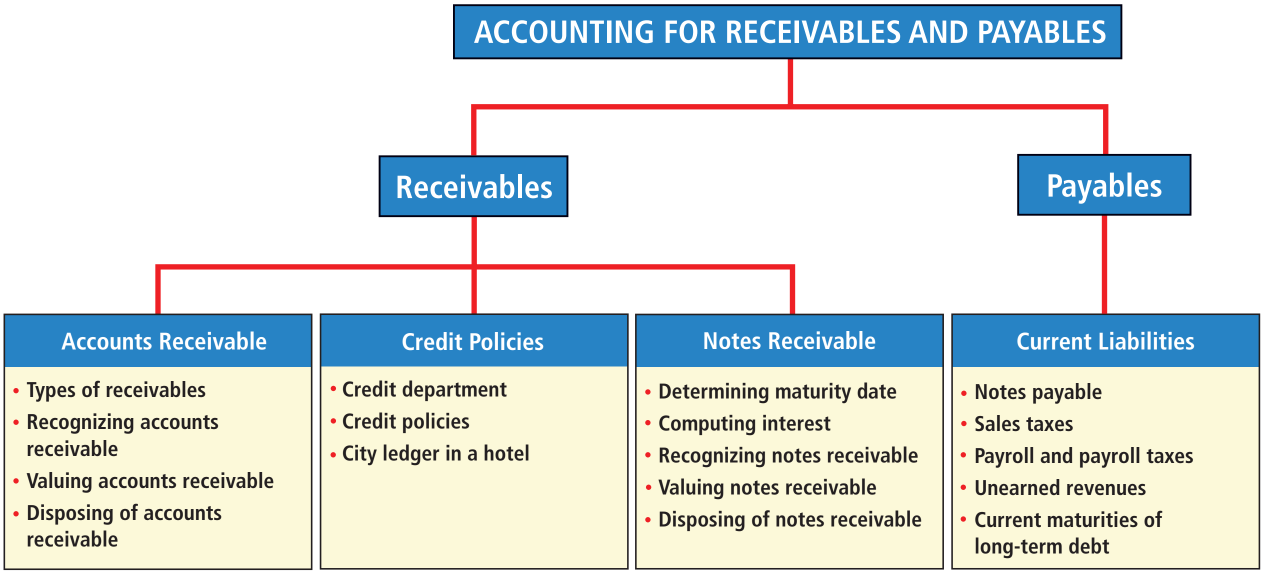
Continued

PREVIEW OF CHAPTER 11

As indicated in the Feature Story, receivables are a significant asset on the books of many hospitality companies. As a consequence, companies must pay close attention to their receivables and carefully manage them. Although receivables are a significant asset, payables are a pertinent liability. These claims, debts, and obligations must be settled or paid at some time in the future by the transfer of assets or services. Failure in paying your bills on time, including sales taxes you collect on behalf of the government, can result in severe penalties. In this chapter, you will learn what journal entries hospitality companies make when products are sold, when cash is collected from those sales, when accounts that cannot be collected are written off, when debts are incurred, and when they are paid.

Thus, our discussion of receivables and current liabilities are as follows.



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STUDY OBJECTIVES (CONTINUED)

6. Compute the maturity date of and interest on notes receivable.
7. Explain how notes receivable are recognized in the accounts.
8. Describe how notes receivable are valued.
9. Describe the entries to record the disposition of notes receivable.
10. Explain a current liability, and identify the major types of current liabilities.
11. Describe the accounting of notes payable.
12. Explain the accounting of other current liabilities.

ACCOUNTS RECEIVABLE

TYPES OF RECEIVABLES

STUDY OBJECTIVE 1

Identify the different types of receivables.

The term *receivables* refers to amounts due from individuals and other companies. They are claims that are expected to be collected in cash. Receivables are frequently classified as accounts, notes, and other:

- **Accounts receivable** are amounts owed by customers on account. They result from the sale of goods and services. These receivables generally are expected to be collected within 30 to 60 days. They are the most significant type of claim held by a company.
- **Notes receivable** are claims for which formal instruments of credit are issued as proof of the debt. A note receivable normally extends for time periods of 60 to 90 days or longer and requires the debtor to pay interest. Notes and accounts receivable that result from sales transactions are often called **trade receivables**.
- **Other receivables** include nontrade receivables. Examples are interest receivable, loans to company officers, advances to employees, and income taxes refundable. These are unusual. Therefore they are generally classified and reported as separate items in the balance sheet.

ETHICS NOTE

Receivables from employees and officers of a company are reported separately in the financial statements. The reason: Sometimes those assets are valued inappropriately or are not based on an "arm's length" transaction.

Three primary accounting issues are associated with accounts receivable:

1. **Recognizing** accounts receivable
2. **Valuing** accounts receivable
3. **Disposing of** accounts receivable

STUDY OBJECTIVE 2

Explain how accounts receivable are recognized in the accounts.

RECOGNIZING ACCOUNTS RECEIVABLE

Recognizing accounts receivable is relatively straightforward. In Chapter 7 we saw how accounts receivable are affected by the sale of merchandise. To illustrate, assume that Jordache Co. on July 1, 2004, sells merchandise on account to Polo Theme Park for $1,000 terms 2/10, n/30. On July 5, Polo returns merchandise worth $100 to Jordache Co. On July 11, Jordache receives payment from Polo for the balance due. The journal entries to record these transactions on the books of Jordache Co. are as follows.

July 1	Accounts Receivable—Polo Theme Park	1,000	
	Sales		1,000
	(To record sales on account)		
July 5	Sales Returns and Allowances	100	
	Accounts Receivable—Polo Theme Park		100
	(To record merchandise returned)		
July 11	Cash ($900 − $18)	882	
	Sales Discounts ($900 × .02)	18	
	Accounts Receivable—Polo Theme Park		900
	(To record collection of accounts receivable)		

A	=	L	+	SE
+1,000				+1,000

A	=	L	+	SE
−100				−100

A	=	L	+	SE
+882				−18
−900				

A discount is given in these situations either to encourage prompt payment or for competitive reasons.

Sometimes, a hospitality business may also need to pay interest. Take the example of Gary's Soup and Salad. Gary's buys produce from Fresh Produce for all its salad bar items. To illustrate, assume Gary's buy on credit. Fresh Produce will make the following entry at the date of sale.

Accounts Receivable	300	
Sales		300
(To record sale of merchandise)		

HELPFUL HINT

The preceding entries are the same as those described in Chapter 7. For simplicity, inventory and cost of goods sold are omitted from this set of journal entries and from end-of-chapter material.

A	=	L	+	SE
+300				+300

Fresh Produce will send Gary's a monthly statement of this transaction and any others that have occurred during the month. If Gary's does not pay in full within 30 days, Fresh Produce adds an interest (financing) charge to the balance due. Although the interest rates vary by region and over time, a common rate of interest is 18 percent per year (1.5% per month).

When financing charges are added, the seller recognizes interest revenue. Assuming that you owe $300 at the end of the month, and Fresh Produce charges 1.5 percent per month on the balance due, the adjusting entry to record interest revenue of $4.50 ($300 × 1.5%) is as follows:

A	=	L	+	SE
+4.50				+4.50

Accounts Receivable	4.50	
Interest Revenue		4.50
(To record interest on amount due)		

Interest revenue is often substantial for many retailers.

ACCOUNTING IN ACTION *Business Insight*

Interest rates on most credit cards are quite high, averaging 18.8 percent. As a result, consumers often look for companies that charge lower rates. Be careful—some companies offer lower interest rates but have eliminated the standard 25-day grace period before finance charges are incurred. Other companies encourage consumers to get more in debt by advertising that only a $1 minimum payment is due on a $1,000 account balance. The less you pay off, the more interest they earn! One bank markets a credit card that allows cardholders to skip a payment twice a year. However, the outstanding balance continues to incur interest. Other credit card companies calculate finance charges initially on two-month, rather than one-month, averages, a practice that often translates into higher interest charges. In short, read the fine print.

VALUING ACCOUNTS RECEIVABLE

STUDY OBJECTIVE 3

Distinguish between the methods and bases used to value accounts receivable.

Once receivables are recorded in the accounts, the next question is: How should receivables be reported in the financial statements? They are reported on the balance sheet as an asset. But determining the *amount* to report is sometimes difficult because some receivables will become uncollectible.

Each customer must satisfy the credit requirements of the seller before the credit sale is approved. Inevitably, though, some accounts receivable become uncollectible. For example, one of your customers may not be able to pay because of a decline in sales due to a downturn in the economy. Similarly, individuals may be laid off from their jobs or be faced with unexpected hospital bills. Credit losses are recorded as debits to **Bad Debts Expense** (or Uncollectible Accounts Expense). Such losses are considered a normal and necessary risk of doing business on a credit basis.

Two methods are used in accounting for uncollectible accounts: (1) the direct write-off method and (2) the allowance method. These methods are explained in the following sections.

Direct Write-off Method for Uncollectible Accounts

Under the **direct write-off method**, when a particular account is determined to be uncollectible, the loss is charged to Bad Debts Expense. Assume, for example, that Executive Conference Center writes off M. E. Doran's $200 balance as uncollectible on December 12. The entry looks like this:

Dec. 12	Bad Debts Expense	200	
	Accounts Receivable—M. E. Doran		200
	(To record write-off of M. E. Doran account)		

A	=	L	+	SE
−200				−200

When this method is used, bad debts expense will show only *actual losses* from uncollectibles. Accounts receivable will be reported at its gross amount.

Although this method is simple, its use can reduce the usefulness of both the income statement and balance sheet. Consider the following example. Assume that in 2004, Quick Buck Cruise Company decided it could increase its revenues by offering holiday cruises to college students without requiring any money down and with no credit-approval process. On campuses across the country it distributed 1,000,000 cruises with a selling price of $800 each. This increased Quick Buck's revenues and receivables by $800,000,000. The promotion was a huge success! The 2004 balance sheet and income statement looked great. Unfortunately, during 2005, nearly 40 percent of the college student customers defaulted on their loans. This made the 2005 income statement and balance sheet look terrible. Illustration 11-1 shows the effect of these events on the financial statements if the direct write-off method is used.

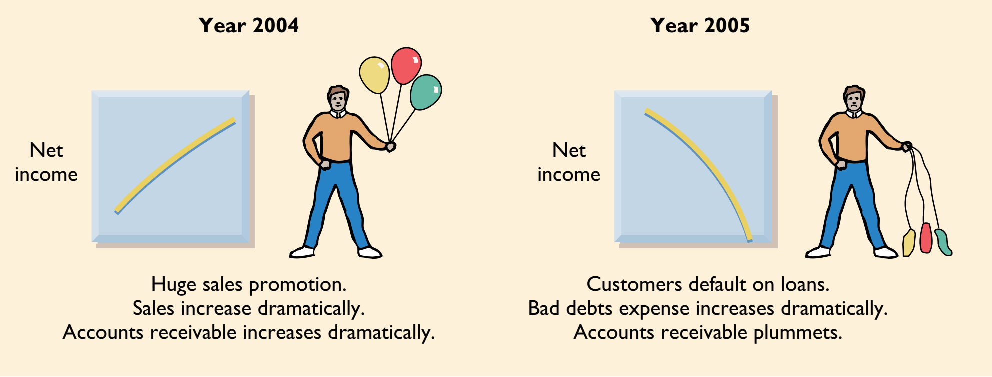


Illustration 11-1
Effects of direct write-off method

Under the direct write-off method, bad debts expense is often recorded in a period different from the period in which the revenue was recorded. No attempt is made to match bad debts expense to sales revenues in the income statement. Nor does the direct write-off method show accounts receivable in the balance sheet at the amount actually expected to be received. **Consequently, unless bad debts losses are insignificant, the direct write-off method is not acceptable for financial reporting purposes.**

Allowance Method for Uncollectible Accounts

The **allowance method** of accounting for bad debts involves estimating uncollectible accounts at the end of each period. This provides better matching on the income statement and ensures that receivables are stated at their cash (net) realizable value on the balance sheet. **Cash (net) realizable value** is the net amount expected to be received in cash. It excludes amounts that the company estimates it will not collect. Receivables are therefore reduced by estimated uncollectible receivables in the balance sheet through use of this method.

The allowance method is required for financial reporting purposes when bad debts are material in amount. It has three essential features:

HELPFUL HINT
In this context, *material* means significant or important to financial statement users.

1. Uncollectible accounts receivable are *estimated*. This estimate is treated as an expense and is matched against sales in the same accounting period in which the sales occurred.

2. Estimated uncollectibles are debited to Bad Debts Expense and are credited to Allowance for Doubtful Accounts (a contra asset account) through an adjusting entry at the end of each period.
3. When a specific account is written off, actual uncollectibles are debited to Allowance for Doubtful Accounts and credited to Accounts Receivable.

RECORDING ESTIMATED UNCOLLECTIBLES. To illustrate the allowance method, assume that Hampson Hotels has credit sales to various restaurants of $1,200,000 in 2004. Of this amount, $200,000 remains uncollected at December 31. The credit manager estimates that $12,000 of these sales will be uncollectible. The adjusting entry to record the estimated uncollectibles looks like this:

A	=	L	+	SE
−12,000				−12,000

Dec. 31	Bad Debts Expense	12,000	
	Allowance for Doubtful Accounts		12,000
	(To record estimate of uncollectible accounts)		

Bad Debts Expense is reported in the income statement as an operating expense (usually as a selling expense). Thus, the estimated uncollectibles are matched with sales in 2004. The expense is recorded in the same year the sales are made.

Allowance for Doubtful Accounts shows the estimated amount of claims on customers that are expected to become uncollectible in the future. This contra account is used instead of a direct credit to Accounts Receivable because we do not know which customers will not pay. The credit balance in the allowance account will absorb the specific write-offs when they occur. It is deducted from Accounts Receivable in the current assets section of the balance sheet as shown in Illustration 11-2.

Illustration 11-2

Presentation of allowance for doubtful accounts

HAMPSON HOTELS
Balance Sheet (partial)

Current assets		
Cash		$ 14,800
Accounts receivable	**$200,000**	
Less: Allowance for doubtful accounts	**12,000**	**188,000**
Merchandise inventory		310,000
Prepaid expense		25,000
Total current assets		$537,800

INTERNATIONAL NOTE

The Finance Ministry in Japan noted that financial institutions should make better disclosure of bad loans. This disclosure would help depositors pick healthy banks.

The amount of $188,000 in Illustration 11-2 represents the expected cash realizable value of the accounts receivable at the statement date. **Allowance for Doubtful Accounts is not closed at the end of the fiscal year.**

RECORDING THE WRITE-OFF OF AN UNCOLLECTIBLE ACCOUNT. Companies use various methods of collecting past-due accounts, such as letters, calls, and legal action. When all means of collecting a past-due account have been exhausted and collection appears impossible, the account should be written off. In the credit card industry, for example, it is standard practice to write off accounts that are 210 days past due. To prevent premature or unauthorized write-offs, each write-off should be formally approved in writing by management. To maintain good internal control, authorization to write off accounts should not be given to someone who also has daily responsibilities related to cash or receivables.

To illustrate a receivables write-off, assume that the vice president of finance of Hampson Hotel authorizes a write-off of the $500 balance owed by R. A. Cybercafe on March 1, 2005:

Mar. 1	Allowance for Doubtful Accounts	500	
	Accounts Receivable—R. A. Cybercafe		500
	(Write-off of R. A. Cybercafe account)		

A	=	L	+	SE
+500				
−500				

Bad Debts Expense is not increased when the write-off occurs. **Under the allowance method, every bad debt write-off is debited to the allowance account rather than to Bad Debts Expense.** A debit to Bad Debts Expense would be incorrect because the expense has already been recognized when the adjusting entry was made for estimated bad debts. Instead, the entry to record the write-off of an uncollectible account reduces both Accounts Receivable and the Allowance for Doubtful Accounts. After posting, the general ledger accounts will appear as in Illustration 11-3.

Illustration 11-3
General ledger balances after write-off

Accounts Receivable				Allowance for Doubtful Accounts			
Jan. 1 Bal.	200,000	Mar. 1	**500**	Mar. 1	**500**	Jan. 1 Bal.	12,000
Mar. 1 Bal.	199,500					Mar. 1 Bal.	11,500

A write-off affects only balance sheet accounts. The write-off of the account reduces both Accounts Receivable and Allowance for Doubtful Accounts. Cash realizable value in the balance sheet, therefore, remains the same, as shown in Illustration 11-4.

Illustration 11-4
Cash realizable value comparison

	Before Write-off	**After Write-off**
Accounts receivable	$200,000	$199,500
Allowance for doubtful accounts	12,000	11,500
Cash realizable value	**$188,000**	**$188,000**

RECOVERY OF AN UNCOLLECTIBLE ACCOUNT. Occasionally, a company collects from a customer after the account has been written off. Two entries are required to record the recovery of a bad debt: (1) The entry made in writing off the account is reversed to reinstate the customer's account. (2) The collection is journalized in the usual manner.

To illustrate, assume that on July 1, R. A. Ware pays the $500 amount that had been written off on March 1. These are the entries:

	(1)		
July 1	Accounts Receivable—R. A. Cybercafe	500	
	Allowance for Doubtful Accounts		500
	(To reverse write-off of R. A. Cybercafe account)		

A	=	L	+	SE
+500				
−500				

	(2)		
July 1	Cash	500	
	Accounts Receivable—R. A. Cybercafe		500
	(To record collection from R. A. Cybercafe)		

A	=	L	+	SE
+500				
−500				

Note that the recovery of a bad debt, like the write-off of a bad debt, affects only balance sheet accounts. The net effect of the two entries above is a debit to Cash and a credit to Allowance for Doubtful Accounts for $500. Accounts Receivable is debited and the Allowance for Doubtful Accounts is credited in entry (1) for two reasons: First, the company made an error in judgment when it wrote off the account receivable. Second, after R. A. Cybercafe did pay, Accounts Re-

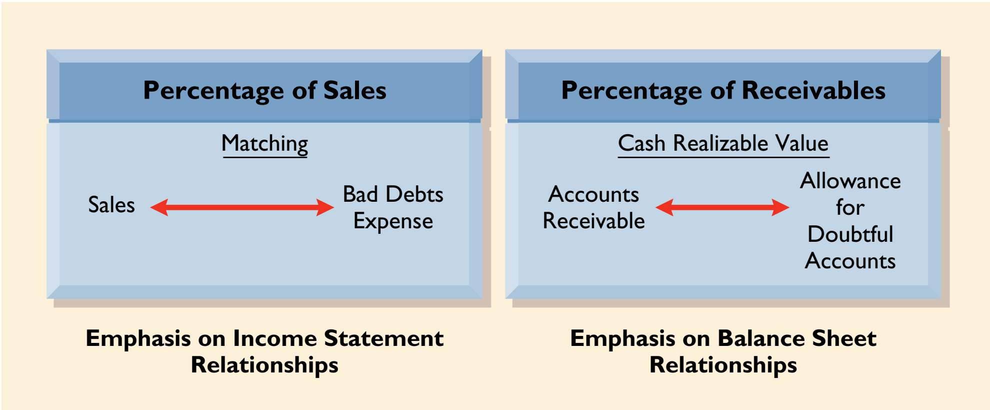
HELPFUL HINT
Like the write-off, a recovery does not involve the income statement.

ceivable in the general ledger and R.A. Cybercafe's account in the subsidiary ledger should show the collection for possible future credit purposes.

BASES USED FOR ALLOWANCE METHOD. To simplify the preceding explanation, we assumed we knew the amount of the expected uncollectibles. In "real life," companies must estimate that amount if they use the allowance method. Two bases are used to determine this amount: (1) percentage of sales, and (2) percentage of receivables. Both bases are generally accepted. The choice is a management decision. It depends on the relative emphasis that management wishes to give to expenses and revenues on the one hand or to cash realizable value of the accounts receivable on the other. The choice is whether to emphasize income statement or balance sheet relationships. Illustration 11-5 compares the two bases.

Illustration 11-5

Comparison of bases for estimating uncollectibles



The **percentage of sales basis** results in a better matching of expenses with revenues—an income statement viewpoint. The **percentage of receivables basis** produces the better estimate of cash realizable value—a balance sheet viewpoint. Under both bases, it is necessary to determine the company's past experience with bad debt losses.

In the percentage of sales basis, management estimates what percentage of credit sales will be uncollectible. This percentage is based on past experience and anticipated credit policy.

The percentage is applied to either total credit sales or net credit sales of the current year. To illustrate, assume that the Gonzalez Hotel elects to use the percentage of sales basis. It concludes that 1 percent of net credit sales will become uncollectible. If net credit sales for 2004 are $800,000, the estimated bad debts expense is $8,000 (1% × $800,000). The adjusting entry is:

A	=	L	+	SE
−8,000				−8,000

Dec. 31	Bad Debts Expense	8,000	
	Allowance for Doubtful Accounts		8,000
	(To record estimated bad debts for year)		

After the adjusting entry is posted, assuming the allowance account already has a credit balance of $1,723, the accounts of Gonzalez Hotel will look like Illustration 11-6:

Illustration 11-6

Bad debts accounts after posting

Bad Debts Expense		Allowance for Doubtful Accounts	
Dec. 31 Adj. **8,000**			Bal. 1,723
			Dec. 31 Adj. **8,000**
			Bal. 9,723

This basis of estimating uncollectibles emphasizes the matching of expenses with revenues. As a result, Bad Debts Expense will show a direct percentage relationship to the sales base on which it is computed. **When the adjusting entry is made, the existing balance in Allowance for Doubtful Accounts is disregarded.** The adjusted balance in this account should be a reasonable approximation of the uncollectible receivables. If actual write-offs differ significantly from the amount estimated, the percentage for future years should be modified.

Under the *percentage of receivables basis*, management estimates what percentage of receivables will result in losses from uncollectible accounts. An **aging schedule** is prepared, in which customer balances are classified by the length of time they have been unpaid. Because of its emphasis on time, the analysis is often called **aging the accounts receivable**.

ACCOUNTING IN ACTION Business Insight

Accounts receivable in a country club is very important. It represents the majority of any additional income a club may earn besides the regular membership fees. Thus, on-time billing so that payments can be received will ensure a healthy cash flow for a club. Still today, many clubs need to mail the signed chits from their members with the month-end billing. The amount of paperwork involved can be tremendous. One country club adopted electronic document imaging whereby the chits are scanned into a PC and indexed so the image can be mailed to the members. With the advances in technology, such equipment has become very affordable. This process not only saves staff time in inefficient filing and copying procedures, but the accounting system can also be programmed so that it will compare its database to the imaging database to make certain proper billing is accomplished.

SOURCE: D. Pacheco, "Electronic document management," *Bottomline,* 15(8), 122–23, (2001).

After the accounts are aged, the expected bad debt losses are determined. This is done by applying percentages based on past experience to the totals in each category. The longer a receivable is past due, the less likely it is to be collected. So, the estimated percentage of uncollectible debts increases as the number of days past due increases. An aging schedule for Dart Day Spa is shown in Illustration 11-7. Note the increasing percentages from 2 to 40 percent.

Illustration 11-7
Aging schedule

			Number of Days Past Due			
Customer	**Total**	**Not Yet Due**	**1–30**	**31–60**	**61–90**	**Over 90**
T. E. Adert	$ 600		$ 300		$ 200	$ 100
R. C. Bortz	300	$ 300				
B. A. Carl	450		200	$ 250		
O. L. Diker	700	500			200	
T. O. Ebbet	600			300		300
Others	36,950	26,200	5,200	2,450	1,600	1,500
	$39,600	$27,000	$5,700	$3,000	$2,000	$1,900
Estimated Percentage Uncollectible		2%	4%	10%	20%	40%
Total Estimated Bad Debts	$ 2,228	$ 540	$ 228	$ 300	$ 400	$ 760

HELPFUL HINT
The higher percentages are used for the older categories because the longer an account is past due, the less likely it is to be collected.

Total estimated bad debts for Dart Day Spa ($2,228) represent the amount of existing customer claims expected to become uncollectible in the future. This amount represents the required balance in Allowance for Doubtful Accounts at the balance sheet date. **The amount of the bad debt adjusting entry is the difference between the required balance and the existing balance in the allowance account**. If the trial balance shows Allowance for Doubtful Accounts with a credit balance of $528, an adjusting entry for $1,700 ($2,228 − $528) is necessary, as shown below.

A	=	L	+	SE
−1,700				−1,700

Dec. 31	Bad Debts Expense	1,700	
	Allowance for Doubtful Accounts		1,700
	(To adjust allowance account to total estimated uncollectibles)		

After the adjusting entry is posted, the accounts of the Dart Day Spa will look like Illustration 11-8:

Illustration 11-8

Bad debts accounts after posting

Bad Debts Expense		Allowance for Doubtful Accounts	
Dec. 31 Adj. **1,700**			Bal. 528
			Dec. 31 Adj. **1,700**
			Bal. 2,228

Occasionally the allowance account will have a *debit balance* prior to adjustment. This occurs when write-offs during the year have exceeded previous provisions for bad debts. In such a case *the debit balance is added to the required balance* when the adjusting entry is made. Thus, if there had been a $500 debit balance in the allowance account before adjustment, the adjusting entry would have been for $2,728 ($2,228 + $500) to arrive at a credit balance of $2,228.

The percentage of receivables method will normally result in the better approximation of cash realizable value. But it will not result in the better matching of expenses with revenues if some customers' accounts are more than one year past due. In such a case, bad debts expense for the current period would include amounts related to the sales of a prior year.

ACCOUNTING IN ACTION *Business Insight*

Although many individuals pay for their hotel stay with a credit card, there are many others, especially business groups, that ask to be billed to a master account. These invoices are often thousands of dollars. An association holding an annual convention in a hotel might have 20 to 30 rooms blocked for its officers, meeting space rentals, breakfasts, luncheons, dinners, and breaks, all charged to a single master bill. It is, therefore, imperative that hotel controllers try to collect the funds as soon as possible. A number of hotel companies send bills to their customers via Federal Express or other courier services if such accounts are more than $25,000. Why? The customer will have to sign for the delivery of the bill. This eliminates the excuse some customers use, saying they never "received" the bill so they are not at fault for delinquent payment.

BEFORE YOU GO ON...

REVIEW IT

1. What is the primary criticism of the direct write-off method?
2. Explain the difference between the percentage of sales and the percentage of receivables methods.

DO IT

Brule Gourmet has been in business 5 years. The ledger at the end of the current year shows: Accounts Receivable $30,000, Sales $180,000, and Allowance for Doubtful Accounts with a **debit** balance of $2,000. Bad debts are estimated to be 10 percent of receivables. Prepare the entry to adjust the Allowance for Doubtful Accounts.

ACTION PLAN

- Report receivables at their cash (net) realizable value.
- Estimate the amount the company does not expect to collect.
- Consider the existing balance in the allowance account when using the percentage of receivables basis.

SOLUTION

The following entry should be made to bring the balance in the Allowance for Doubtful Accounts up to a balance of $3,000 (0.1 × $30,000):

Bad Debts Expense	5,000	
Allowance for Doubtful Accounts		5,000
(To record estimate of uncollectible accounts)		

Related exercise material: 11-3 and 11-11.

THE NAVIGATOR

DISPOSING OF ACCOUNTS RECEIVABLE

STUDY OBJECTIVE 4

Describe the entries to record the disposition of accounts receivable.

In the normal course of events, accounts receivable are collected in cash and removed from the books. However, as credit sales and receivables have grown in significance, their "normal course of events" has changed. Companies now frequently sell their receivables to another company for cash, thereby shortening the cash-to-cash operating cycle.

Receivables are sold for two major reasons:

1. **Receivables may be sold because they may be the only reasonable source of cash.** When money is tight, companies may not be able to borrow money in the usual credit markets. Or, if money is available, the cost of borrowing may be prohibitive.
2. **Billing and collection are often time consuming and costly.** It is often easier for a retailer to sell the receivable to another party with expertise in billing and collection matters. Credit card companies such as **MasterCard**, **VISA**, **American Express**, and **Diners Club** specialize in billing and collecting accounts receivable.

HELPFUL HINT

Two common expressions apply here:

1. Time is money. That is, waiting for the normal collection process costs money.
2. A bird in the hand is worth two in the bush. That is, getting cash now is better than getting it later.

Sale of Receivables

A common sale of receivables is a sale to a factor. A **factor** is a finance company or bank that buys receivables from businesses and then collects the payments directly from the customers. Factoring is a multibillion-dollar business.

Factoring arrangements vary widely. Typically the factor charges a commission to the company that is selling the receivables. This fee ranges from 1 to 3 percent of the amount of receivables purchased. To illustrate, assume that Hendredon Resort factors $600,000 of receivables to Federal Factors. Federal Factors assesses a service charge of 2 percent of the amount of receivables sold. The journal entry to record the sale by Hendredon Resort is as follows:

A	=	L	+	SE
+588,000				−12,000
−600,000				

Cash	588,000	
Service Charge Expense (2% × $600,000)	12,000	
Accounts Receivable		600,000
(To record the sale of accounts receivable)		

If the company often sells its receivables, the service charge expense (such as that incurred by Hendredon) is recorded as selling expense. If receivables are sold infrequently, this amount may be reported in the "other expenses and losses" section of the income statement.

Credit Card Sales

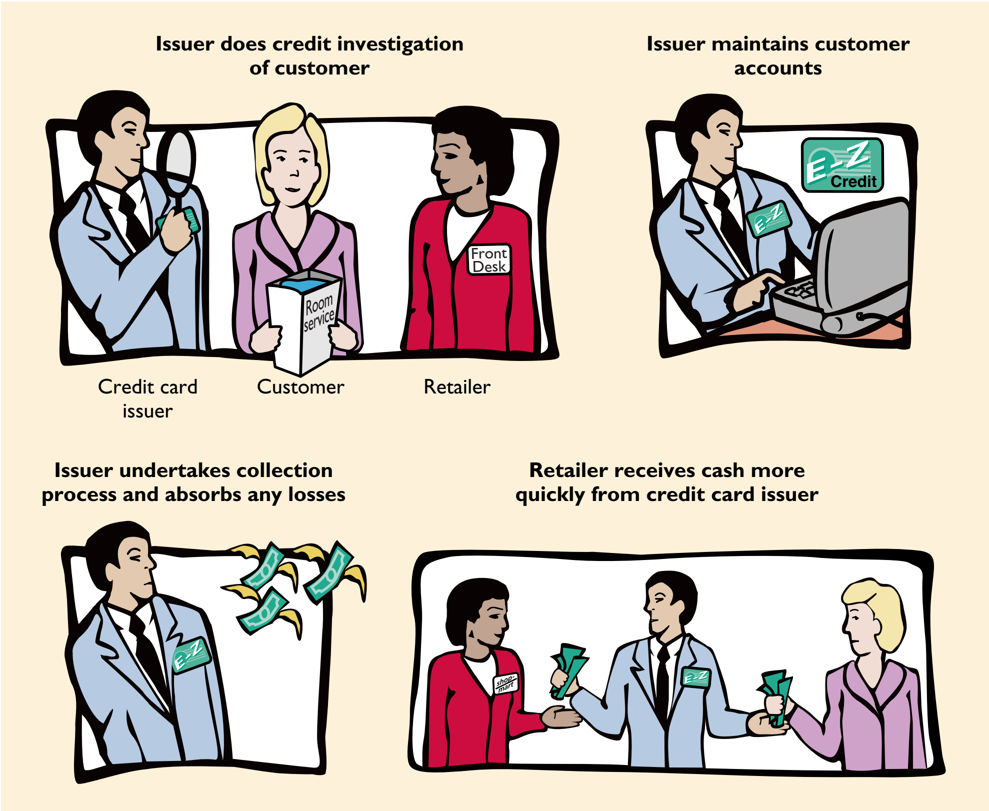
HELPFUL HINT
By accepting credit cards such as VISA, a retailer can increase its sales while reducing its bad debts expense.

One billion credit cards were estimated to be in use recently—more than three credit cards for every man, woman, and child in this country. Companies such as **VISA**, **MasterCard**, **Discover**, **American Express**, and **Diners Club** offer national credit cards. Three parties are involved when national credit cards are used in making retail sales: (1) the credit card issuer, who is independent of the retailer, (2) the retailer, and (3) the customer. A retailer's acceptance of a national credit card is another form of selling (factoring) the receivable.

The major advantages of these national credit cards to the retailer are shown in Illustration 11–9. In exchange for these advantages, the retailer pays the credit card issuer a fee of 2 to 6 percent of the invoice price for its services.

Illustration 11-9

Advantages of credit cards to the retailer



CASH SALES: VISA AND MASTERCARD. Sales resulting from the use of **VISA** and **MasterCard** are considered cash sales by the retailer. These cards are issued by banks. Upon receipt of credit card sales slips from a retailer, the bank immediately adds the amount to the seller's bank balance, deducting a fee of 2 to 4 percent of the credit card sales slips for this service. These credit card sales slips are recorded in the same manner as checks deposited from a cash sale.

To illustrate, Lee Lenertz purchases $1,000 of compact discs for her restaurant from Brieschke Music Co., using her VISA First Bank Card. The service fee that Castle Bank charges is 3 percent. The entry to record this transaction by Brieschke Music is as follows.

Cash	970	
Service Charge Expense	30	
Sales		1,000
(To record VISA credit card sales)		

A	=	L	+	SE
+970				−30
				+1,000

CREDIT SALES: AMERICAN EXPRESS AND DINERS CLUB. Sales using **American Express** and **Diners Club** cards are reported as credit sales, not cash sales. Conversion into cash does not occur until these companies remit the net amount to the seller. To illustrate, assume that Four Seasons restaurant accepts an American Express card for a $300 bill. The entry for the sale by Four Seasons, assuming a 5 percent service fee, looks like this:

Accounts Receivable—American Express	285	
Service Charge Expense	15	
Sales		300
(To record American Express credit card sales)		

A	=	L	+	SE
+285				−15
				+300

American Express will subsequently pay the restaurant $285. The restaurant will record this payment as follows.

Cash	285	
Accounts Receivable—American Express		285
(To record redemption of credit card billings)		

A	=	L	+	SE
+285				
−285				

Service Charge Expense is reported by the restaurant as a selling expense in the income statement.

BEFORE YOU GO ON...

REVIEW IT

1. Why do companies sell their receivables?
2. What is the journal entry when a company sells its receivables to a factor?
3. How are sales using a VISA or MasterCard reported? Is a sale using an American Express card recorded differently? Explain.

DO IT

Peter M. Dell Food Wholesalers Co. has been expanding faster than it can raise capital. According to its local banker, the company has reached its debt ceiling. Dell's customers are slow in paying (60–90 days), but its suppliers (creditors) are demanding 30-day payment. Dell has a cash-flow problem.

Dell needs $120,000 in cash to safely cover next Friday's employee payroll. Its balance of outstanding receivables totals $750,000. What might Dell do to alleviate this cash crunch? Record the entry that Dell would make when it raises the needed cash.

ACTION PLAN

- To speed up the collection of cash, sell receivables to a factor.
- Calculate service charge expense as a percentage of the factored receivables.

SOLUTION: Assuming that Dell Food Wholesalers factors $125,000 of its accounts receivable at a 1 percent service charge, the following entry would be made.

Cash	123,750	
Service Charge Expense	1,250	
Accounts Receivable		125,000
(To record sale of receivables to factor)		

Related exercise material: 11-6.

THE NAVIGATOR

CREDIT POLICIES

STUDY OBJECTIVE 5

Explain why credit policies are needed in the hospitality industry.

Credit policies are crucial in the hospitality industry, especially in the hotel industry where functions and parties are held. Good credit policies will ensure guest satisfaction, lessen misunderstanding, and ensure that the hospitality business will be able to collect its revenues in a timely manner.

THE CREDIT DEPARTMENT

The credit department of a hotel is normally part of the accounting department. Its function is to set policies and also work with the sales staff to check the credit of potential guests. For example, a student organization approaches a hotel for its year-end banquet. This hotel does not know the organization or any of its personnel. The credit department will ask the hotel sales representatives to have the student organization liaison complete a credit application form. The form asks for information such as bank accounts, businesses the student organization has dealt with before, address, phone number, and the like. The credit department will then do its due diligence to hopefully award credit to this organization while the sales personnel discusses the banquet and the needs of this new potential client. Once credit is approved, it is also customary for a hotel to ask for a deposit and have a contract signed. One might think that all these may be a bit too much work. However, consider a function that is $50 per person. If 100 people attend, it is $5,000. All you need is one bad incident and the hotel's profit for the event is gone.

THE CREDIT POLICY PRIOR, DURING, AND POST EVENT

Policies should always be followed; but in the hospitality business, when you are dealing with people, they may not be good event planners. This means that unexpected questions will arise. Imagine a wedding where the bride's parents have everything set with the hotel staff for a reception of 200 people. Despite the advice of the sales staff that the party might need more food since it is held during dinnertime, the family goes with its own estimate. The credit approval is only for a certain amount. The hotel approves the credit to a certain amount and requests and requires a deposit from the wedding party.

On the day of the wedding, 40 unexpected guests arrive. Within half an hour into the reception, the food is gone. The groom's family is telling the banquet captain to bring out more food. Some guests ask the waitstaff for additional canapés. Who actually has the authority to order more food on the spot? The bride wants to add more champagne for the guests. If champagne is $50 a bottle and the bride wants another 10 bottles, that is $500. Should the hotel staff take her order? What if later on the parents do not agree with this and do not want to pay? Should they write a check of $500 right there? Can they be billed later? When it comes to money, all these polices should be set ahead of time so that embarrassing moments like these will not occur.

CITY LEDGER OF A HOTEL

As mentioned in Chapter 2, a hotel keeps two ledgers: the guest ledger and the city ledger. The guest ledger is associated with guests staying at the hotel, while the city ledger contains all other billings. As you can well imagine, it is obviously easier to collect from people who are staying in your hotel because they are physically there. However, for city ledger accounts, collection can be challenging at times.

The city ledger can include individual billings, corporate accounts, group and travel agents, and banquet accounts. An individual might want to rent a function room for a meeting. Corporations might have training sessions for all their first-level managers. They might bring anywhere from 50 to 100 people to a hotel for a few days. The guest rooms, function rooms, and food and beverage bills can add up to thousands of dollars.

Besides training, corporations also hold incentive trips to reward their sales staff. These trips can be big affairs and are wonderful business for hotels. Associations hold annual membership conferences, trade shows, and conventions. Travel agencies book tour groups in hotels. Weddings, birthdays, and anniversaries are all common functions. Did we mention how much these functions can cost? A wealthy businessman once held a dinner for about 80 of his friends and spent more than $75,000, close to $1,000 per person. Of course, this wealthy person paid his bill.

What if, *just what if*, the hotel does not have a good credit policy, or no good accounting personnel to work its city ledger for collection? Well for one thing, the hotel would not be in business for long. Therefore, having a good credit department within the accounting office, good credit policies, and good management of the city ledger, are crucial to a successful operation.

In a restaurant, club, theme park, and other hospitality businesses, it is also important to have such practices. However, their businesses are less susceptible to losses in accounts receivables. Most customers pay by cash or credit cards in restaurants. Even if a restaurant caters functions, it will normally ask for a good amount of deposit up front. Clubs, due to their tax status, cannot take more than 15 percent of their business from nonmembers. In addition, such business normally is referred or sponsored by the members, so there is always a lead to collect if needed.

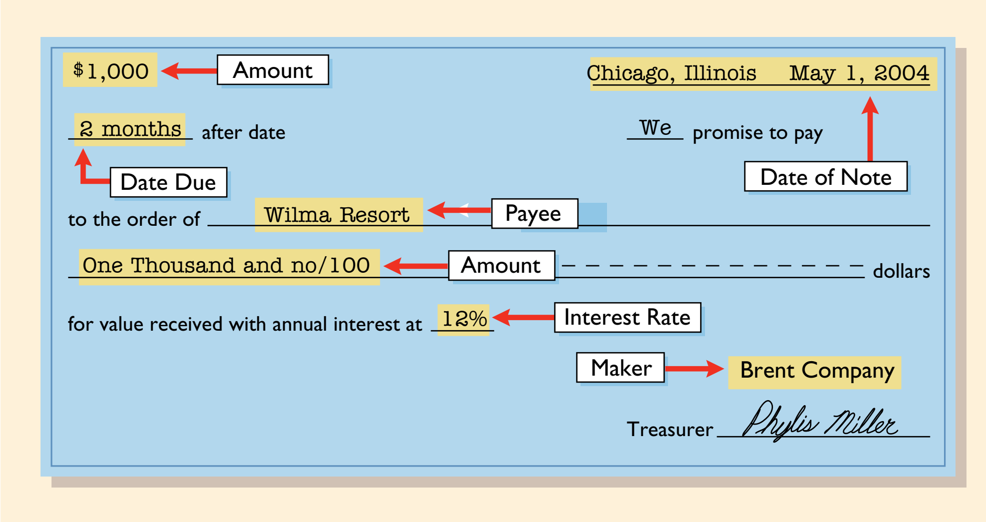
NOTES RECEIVABLE

Credit may also be granted in exchange for a promissory note. A **promissory note** is a written promise to pay a specified amount of money on demand or at a definite time. Promissory notes may be used (1) when individuals and companies lend or borrow money; (2) when the amount of the transaction and the credit period exceed normal limits; or (3) in settlement of accounts receivable.

In a promissory note, the party making the promise to pay is called the **maker**. The party to whom payment is to be made is called the **payee**. The payee may be specifically identified by name or may be designated simply as the bearer of the note. In the note shown in Illustration 11-10, Brent Company is the maker, Wilma Resort is the payee. To Wilma Resort, the promissory note is a note receivable; to Brent Company, it is a note payable.

Illustration 11-10

Promissory note



HELPFUL HINT

Who are the two key parties to a note, and what entry does each party make when the note is issued?

Answer:

1. The maker, Brent Company, credits Notes Payable.
2. The payee, Wilma Resort, debits Notes Receivable.

Notes receivable give the payee a stronger legal claim to assets than accounts receivable. Like accounts receivable, notes receivable can be readily sold to another party. Promissory notes are negotiable instruments (as are checks), which means that they can be transferred to another party by endorsement.

Notes receivable are frequently accepted from customers who need to extend the payment of an account receivable. They are often required from high-risk customers. In some industries (such as the pleasure boat industry), all credit sales are supported by notes. The majority of notes originate from loans. The basic issues in accounting for notes receivable are the same as those for accounts receivable:

1. **Recognizing** notes receivable
2. **Valuing** notes receivable
3. **Disposing of** notes receivable

On the following pages, we will look at these issues. Before we do, we need to consider two issues that did not apply to accounts receivable: maturity date and computing interest.

DETERMINING THE MATURITY DATE

STUDY OBJECTIVE 6

Compute the maturity date of and interest on notes receivable.

When the life of a note is expressed in terms of months, the due date when it matures is found by counting the months from the date of issue. For example, the maturity date of a three-month note dated May 1 is August 1. A note drawn on the last day of a month matures on the last day of a subsequent month. That is, a July 31 note due in two months matures on September 30. When the due date is stated in terms of days, you need to count the exact number of days to determine the maturity date. **In counting, the date the note is issued is omitted but the due date is included**. For example, the maturity date of a 60-day note dated July 17 is September 15, computed in Illustration 11-11.

Illustration 11-11

Computation of maturity date

Term of note		60 days
July (31 − 17)	14	
August	31	45
Maturity date: September		**15**

The due date (maturity date) of a promissory note may be stated in one of three ways, as shown in Illustration 11-12.

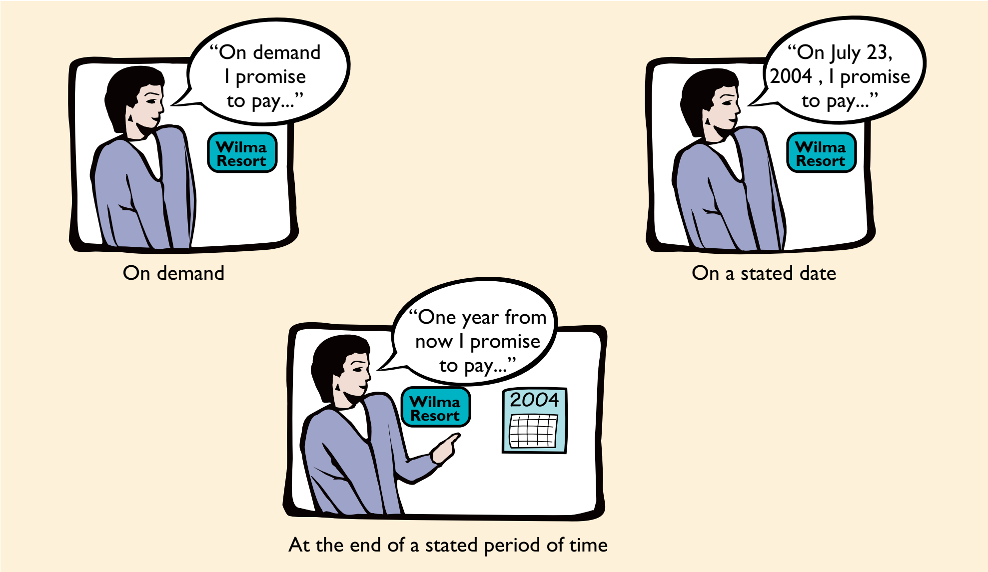


Illustration 11-12

Maturity date of different notes

COMPUTING INTEREST

As indicated in Chapter 4, Illustration 11-13 shows the basic formula for computing interest on an interest-bearing note:

Face Value of Note × Annual Interest Rate × Time in Terms of One Year = Interest

Illustration 11-13

Formula for computing interest

The interest rate specified in a note is an *annual* rate of interest. The time factor in the formula above expresses the fraction of a year that the note is outstanding. When the maturity date is stated in days, the time factor is often the number of days divided by 360. When the due date is stated in months, the time factor is the number of months divided by 12. Computation of interest for various time periods is shown in Illustration 11-14.

HELPFUL HINT
The interest rate specified is the *annual* rate.

Terms of Note	Interest Computation
	Face × Rate × Time = Interest
$ 730, 18%, 120 days	$ 730 × 18% × 120/360 = $ 43.80
$1,000, 15%, 6 months	$1,000 × 15% × 6/12 = $ 75.00
$2,000, 12%, 1 year	$2,000 × 12% × 1/1 = $240.00

Illustration 11-14

Computation of interest

There are many different ways to calculate interest. The computation above assumed 360 days for the length of the year. Many financial institutions use 365 days. It is more profitable to use 360 days; the holder of the note receives more interest than if 365 days are used. For homework problems, assume 360 days.

STUDY OBJECTIVE 7

Explain how notes receivable are recognized in the accounts.

RECOGNIZING NOTES RECEIVABLE

To illustrate the basic entry for notes receivable, we will use the $1,000, two-month, 12 percent promissory note on page 366. Assuming that the note was written to settle an open account, the entry for the receipt of the note by Wilma Resort is:

A	=	L	+	SE
+1,000				
−1,000				

May 1	Notes Receivable	1,000	
	Accounts Receivable—Brent Company		1,000
	(To record acceptance of Brent Company note)		

Observe that the note receivable is recorded at its **face value**, the value shown on the face of the note. No interest revenue is reported when the note is accepted because the revenue recognition principle does not recognize revenue until earned. Interest is earned (accrued) as time passes.

If a note is exchanged for cash, the entry is a debit to Notes Receivable and a credit to Cash in the amount of the loan.

STUDY OBJECTIVE 8

Describe how notes receivable are valued.

VALUING NOTES RECEIVABLE

Valuing short-term notes receivable is the same as valuing accounts receivable. Like accounts receivable, short-term notes receivable are reported at their **cash (net) realizable value**. The notes receivable allowance account is Allowance for Doubtful Accounts. The estimations involved in determining cash realizable value and in recording bad debts expense and related allowance are similar.

ACCOUNTING IN ACTION *International Insight*

Long-term receivables do pose additional estimation problems. For example, banks that loaned money to developing countries have often found it difficult to collect on those receivables. At one time, banks were owed $1.3 trillion by developing countries. (A trillion dollars is a lot of money—enough to give every man, woman, and child in the world $250 each.) Banks made these loans for various reasons: (1) to provide stability to these governments and increase trade, (2) in the belief that governments would never default on payment, and (3) with the desire to increase banks' income by lending. Determining the proper allowance is understandably difficult for these types of long-term receivables.

STUDY OBJECTIVE 9

Describe the entries to record the disposition of notes receivable.

DISPOSING OF NOTES RECEIVABLE

Notes may be held to their maturity date, at which time the face value plus accrued interest is due. Sometimes the maker of the note defaults and an adjustment to the accounts must be made. At other times the holder of the note speeds up the conversion to cash by selling the note. The entries for honoring and dishonoring notes are illustrated below.

Honor of Notes Receivable

A note is **honored** when it is paid in full at its maturity date. For an interest-bearing note, the amount due at maturity is the face value of the note plus interest for the length of time specified on the note.

To illustrate, assume that Betty Hospitality, Inc. lends Wayne Higley Inc. $10,000 on June 1, accepting a four-month, 9 percent interest note. Interest will be $300 ($\$10,000 \times 9\% \times 4/12$). The amount due, the maturity value, will be $10,300. To obtain payment, Betty Hospitality, Inc. (the payee) must present the note either to Wayne Higley Inc. (the maker) or to the maker's duly appointed agent, such as a bank. Assuming that Betty Hospitality, Inc. presents the note to Wayne Higley Inc. on the maturity date, the entry by Betty Hospitality, Inc. to record the collection is:

Oct. 1	Cash	10,300	
	Notes Receivable		10,000
	Interest Revenue		300
	(To record collection of Higley Inc. note)		

A	=	L	+	SE
+10,300				+300
−10,000				

If Betty Hospitality, Inc. prepares financial statements as of September 30, it would be necessary to accrue interest. In this case, the adjusting entry by Betty Hospitality, Inc. would be to record four months' interest ($300), as shown below.

Sept. 30	Interest Receivable	300	
	Interest Revenue		300
	(To accrue 4 months' interest)		

A	=	L	+	SE
+300				+300

When interest has been accrued, at maturity it is necessary to credit Interest Receivable. The entry by Betty Hospitality, Inc. to record the honoring of the Wayne Higley Inc. note on October 1 is:

Oct. 1	Cash	10,300	
	Notes Receivable		10,000
	Interest Receivable		300
	(To record collection of note at maturity)		

A	=	L	+	SE
+10,300				
−10,000				
−300				

In this case, Interest Receivable is credited because the receivable was established in the adjusting entry.

Dishonor of Notes Receivable

A **dishonored note** is a note that is not paid in full at maturity. A dishonored note receivable is no longer negotiable. However, the payee still has a claim against the maker of the note. Therefore the Notes Receivable account is usually transferred to an Account Receivable.

To illustrate, assume that Wayne Higley Inc. on October 1 indicates that it cannot pay at the present time. The entry to record the dishonor of the note depends on whether eventual collection is expected. If Betty Hospitality, Inc. expects eventual collection, the amount due (face value and interest) on the note is debited to Accounts Receivable. Betty Hospitality, Inc. would make the following entry at the time the note is dishonored (assuming no previous accrual of interest).

Oct. 1	Accounts Receivable—Wayne Higley Inc.	10,300	
	Notes Receivable		10,000
	Interest Revenue		300
	(To record the dishonor of Higley Inc. note)		

A	=	L	+	SE
+10,300				+300
−10,000				

If there is no hope of collection, the face value of the note would be written off by debiting the Allowance for Doubtful Accounts. No interest revenue would be recorded because collection will not occur.

Sale of Notes Receivable

The accounting for the sales of notes receivable is recorded similarly to the sale of accounts receivable. The accounting entries for the sale of notes receivable are left for a more advanced course.

BEFORE YOU GO ON . . .

REVIEW IT

1. What is the basic formula for computing interest?
2. At what value are notes receivable reported on the balance sheet?
3. Explain the difference between honoring and dishonoring a note receivable.

DO IT

Gambit Logo Shirts accepts from Leonard Golf Proshop a $3,400, 90-day, 12% note dated May 10 in settlement of Leonard's overdue account. What is the maturity date of the note? What is the entry made by Gambit at the maturity date, assuming Leonard pays the note and interest in full at that time?

ACTION PLAN

- Count the exact number of days to determine the maturity date. Omit the date the note is issued, but include the due date.
- Determine whether interest was accrued. The entry here assumes that no interest has been previously accrued on this note.

SOLUTION: The maturity date is August 8, computed as follows.

Term of note:		90 days
May (31 − 10)	21	
June	30	
July	31	82
Maturity date: August		8

The interest payable at maturity date is $102, computed as follows.

$$\text{Face} \times \text{Rate} \times \text{Time} = \text{Interest}$$
$$\$3{,}400 \times 12\% \times 90/360 = \$102$$

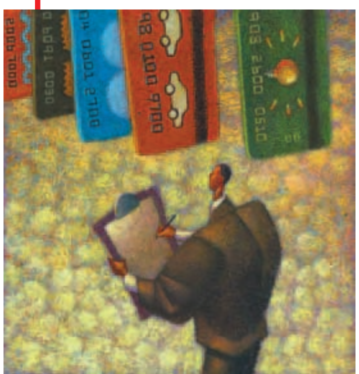
The entry recorded by Gambit Logo Shirts at the maturity date is:

Cash	3,502	
Notes Receivable		3,400
Interest Revenue		102
(To record collection of Leonard note)		

Related exercise material: 11-4, 11-5, 11-12, and 11-13.

THE NAVIGATOR

ACCOUNTING IN ACTION *Business Insight*



Give the man credit. Like most of us, John Galbreath receives piles of unsolicited, "preapproved" credit card applications in the mail. Galbreath doesn't just toss them out, though. He filled out a credit card application on which he stated he was 97 years old and had no income, no telephone, and no Social Security number. In a space inviting him to let the credit card company pay off his other credit card balances, Galbreath said he owed money to the Mafia.

Back came a credit card and a letter welcoming John to the fold with a $1,500 credit limit. Galbreath had requested the card under a false name, John C. Reath, an alias under which he had received two other credit cards—earning exemplary credit. John C. Reath might be a senior citizen with no means, but it seems he paid his bills on time.

SOURCE: "Forbes Informer," edited by Kate Bohner Lewis, *Forbes* (August 14, 1995), p. 19. Reprinted by permission of FORBES Magazine © Forbes Inc., 1995.

WHAT IS A CURRENT LIABILITY?

STUDY OBJECTIVE 10

Explain a current liability, and identify the major types of current liabilities.

As explained in Chapter 5, a **current liability** is a debt with two key features: (1) It can reasonably be expected to be paid from existing current assets or through the creation of other current liabilities. And (2) it will be paid within one year or the operating cycle, whichever is longer. Debts that do not meet *both criteria* are classified as long-term liabilities. Most companies pay current liabilities within one year out of current assets, rather than by creating other liabilities.

Companies must carefully monitor the relationship of current liabilities to current assets. This relationship is critical in evaluating a company's short-term debt-paying ability. A company that has more current liabilities than current assets is usually the subject of some concern because the company may not be able to meet its current obligations when they become due.

HELPFUL HINT
The current liabilities section of the balance sheet gives creditors a good idea of what obligations are coming due.

Current liabilities include notes payable, accounts payable, and unearned revenues. They also include accrued liabilities such as taxes, salaries and wages, and interest payable. The entries for accounts payable and adjusting entries for some current liabilities have been explained in previous chapters. Other types of current liabilities that are often encountered are discussed in the following sections.

NOTES PAYABLE

STUDY OBJECTIVE 11

Describe the accounting for notes payable.

Obligations in the form of written promissory notes are recorded as **notes payable**. Notes payable are often used instead of accounts payable. Doing so gives the lender formal proof of the obligation in case legal remedies are needed to collect the debt. Notes payable usually require the borrower to pay interest and frequently are issued to meet short-term financing needs.

Notes are issued for varying periods. **Those due for payment within one year of the balance sheet date are usually classified as current liabilities.** Most notes are interest bearing.

To illustrate the accounting for notes payable, assume that First National Bank agrees to lend $100,000 on March 1, 2004, if Williams Restaurant signs a $100,000, 12 percent, four-month note. With an interest-bearing promissory note, the amount of assets received upon issuance of the note generally equals the note's face value. Williams Restaurant therefore will receive $100,000 cash and will make the following journal entry:

Mar. 1	Cash	100,000	
	Notes Payable		100,000
	(To record issuance of 12%, 4-month note to First National Bank)		

A	=	L	+	SE
+100,000		+100,000		

Interest accrues over the life of the note and must be recorded periodically. If Williams Restaurant prepares financial statements semiannually, an adjusting entry is required at June 30 to recognize interest expense and interest payable of $4,000 ($100,000 × 12% × 4/12). The formula for computing interest and its application to Williams Restaurant's note are shown in Illustration 11-15.

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest
$100,000	×	12%	×	4/12	=	$4,000

Illustration 11-15
Formula for computing interest

The adjusting entry looks like this:

A	=	L	+	SE
		+4,000		−4,000

June 30	Interest Expense	4,000	
	Interest Payable		4,000
	(To accrue interest for 4 months on First National Bank note)		

In the June 30 financial statements, the current liabilities section of the balance sheet will show notes payable \$100,000 and interest payable \$4,000. In addition, interest expense of \$4,000 will be reported under "other expenses and losses" in the income statement. If Williams prepared financial statements monthly, the adjusting entry at the end of each month would have been \$1,000 (\$100,000 × 12% × 1/12).

At maturity (July 1, 2004), Williams must pay the face value of the note (\$100,000) plus \$4,000 interest (\$100,000 × 12% × 4/12). The entry to record payment of the note and accrued interest is as follows.

A	=	L	+	SE
−104,000		−100,000		
		−4,000		

July 1	Notes Payable	100,000	
	Interest Payable	4,000	
	Cash		104,000
	(To record payment of First National Bank interest-bearing note and accrued interest at maturity)		

SALES TAXES PAYABLE

STUDY OBJECTIVE 12

Explain the accounting for other current liabilities.

As a consumer, you know that when you eat at a restaurant, the food is subject to sales taxes. The tax is expressed as a stated percentage of the sales price. The retailer collects the tax from the customer when the sale occurs. Periodically (usually monthly), the restaurant remits the collections to the state's department of revenue.

Under most state sales tax laws, the amount of the sale and the amount of the sales tax collected must be rung up separately on the cash register. The cash register readings are then used to credit Sales and Sales Taxes Payable. For example, if the March 25 cash register reading for Cooley Restaurant shows sales of \$10,000 and sales taxes of \$600 (sales tax rate of 6%), the entry looks like this:

A	=	L	+	SE
+10,600		+600		+10,000

Mar. 25	Cash	10,600	
	Sales		10,000
	Sales Taxes Payable		600
	(To record daily sales and sales taxes)		

When the taxes are remitted to the taxing agency, Sales Taxes Payable is debited and Cash is credited. The company does not report sales taxes as an expense. It simply forwards to the government the amount paid by the customers. Thus, Cooley serves only as a **collection agent** for the taxing authority.

When sales taxes are not rung up separately on the cash register, they must be extracted from the total receipts. To determine the amount of sales in such cases, divide total receipts by 100 percent plus the sales tax percentage. To illustrate, assume that in the above example Cooley rings up total receipts, which are \$10,600. The receipts from the sales are equal to the sales price (100%) plus the tax percentage (6% of sales), or 1.06 times the sales total. We can compute the sales amount as follows.

$$\$10{,}600 \div 1.06 = \$10{,}000$$

Thus, Cooley Restaurant could find the sales tax amount it must remit to the state by subtracting sales from total receipts (\$10,600 − \$10,000).

HELPFUL HINT

Alternatively, Cooley could find the tax by multiplying sales by the sales tax rate (\$10,000 × 6%).

PAYROLL AND PAYROLL TAXES PAYABLE

Every employer incurs liabilities relating to employees' salaries and wages. One is the amount of wages and salaries owed to employees—**wages and salaries payable**. Another is the amount required by law to be withheld from employees' gross pay. Until these **withholding taxes** (federal and state income taxes, and Social Security taxes) are remitted to the governmental taxing authorities, they are credited to appropriate liability accounts. For example, if a corporation withholds taxes from its employees' wages and salaries, accrual and payment of a $100,000 payroll would be recorded as follows.

March 7	Salaries and Wages Expense	100,000	
	FICA Taxes Payable[1]		7,250
	Federal Income Taxes Payable		21,864
	State Income Taxes Payable		2,922
	Salaries and Wages Payable		67,964
	(To record payroll and withholding taxes for the week ending March 7)		

A	=	L	+	SE
		+7,250		−100,000
		+21,864		
		+2,922		
		+67,964		

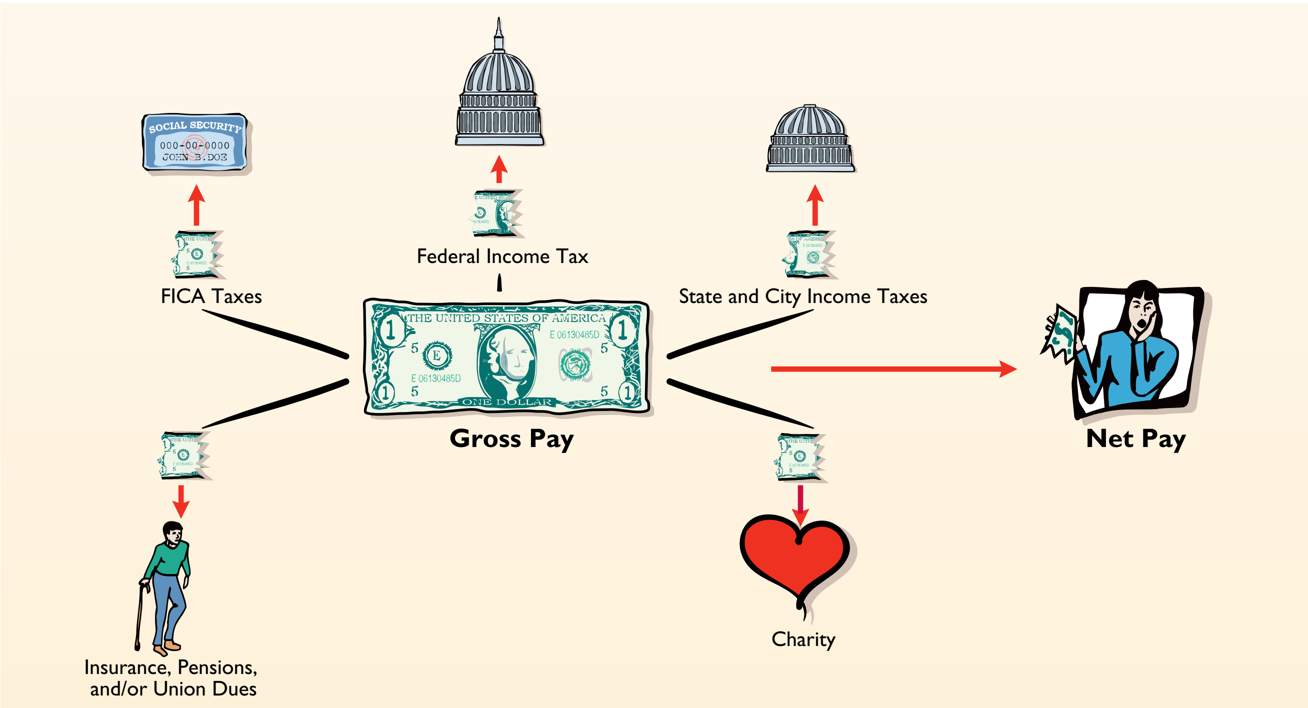
March 11	Salaries and Wages Payable	67,964	
	Cash		67,964
	(To record payment of the March 7 payroll)		

A	=	L	+	SE
−67,964		−67,964		

Illustration 11-16 summarizes the types of payroll deductions.

Illustration 11-16

Payroll deductions



Also, with every payroll, the employer incurs liabilities to pay various **payroll taxes** levied upon the employer. These payroll taxes include the employer's share of Social Security taxes and the state and federal unemployment taxes.

[1]Social Security taxes are commonly referred to as FICA taxes. In 1937, Congress enacted the Federal Insurance Contribution Act (FICA). This act and other payroll issues are discussed in greater detail in Chapter 9.

Based on the $100,000 payroll in the previous example, the following entry would be made to record the employer's expense and liability for these payroll taxes:

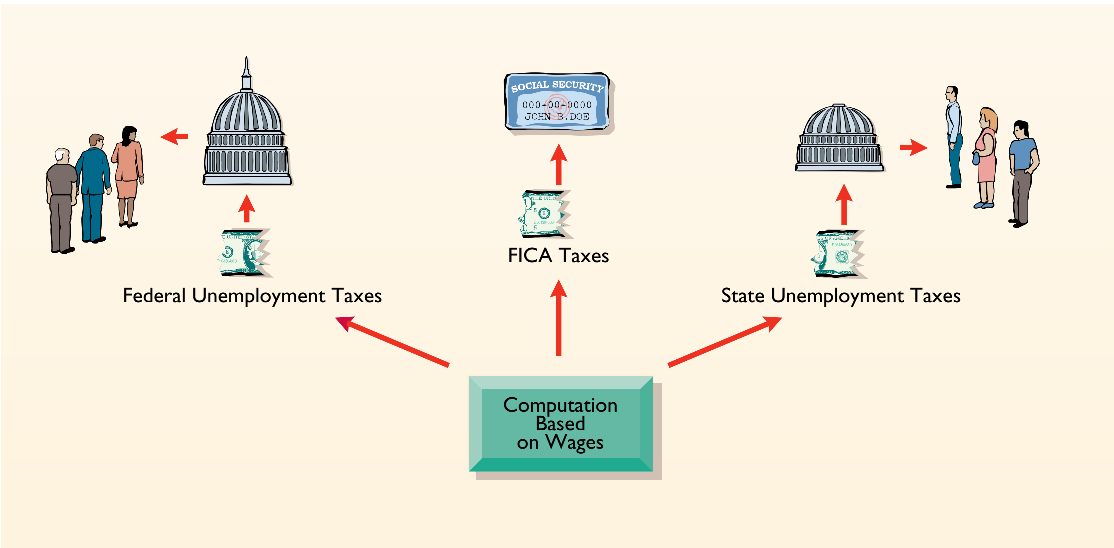
A	=	L	+	SE
		+7,250		−13,450
		+800		
		+5,400		

March 7	Payroll Tax Expense	13,450	
	FICA Taxes Payable		7,250
	Federal Unemployment Taxes Payable		800
	State Unemployment Taxes Payable		5,400
	(To record employer's payroll taxes on March 7 payroll)		

Illustration 11-17

Employer payroll taxes

Illustration 11-17 shows the types of taxes levied on employers.



The payroll and payroll tax liability accounts are classified as current liabilities because they must be paid to employees or remitted to taxing authorities in the near term. Taxing authorities impose substantial fines and penalties on employers if the withholding and payroll taxes are not computed correctly and paid on time.

UNEARNED REVENUES

A hotel, such as **Hilton**, receives a customer's check when a banquet is ordered. An airline company, such as **American Airlines**, receives cash when it sells tickets for future flights. Through these transactions, both companies have incurred unearned revenues—revenues that are received before goods are delivered or services are rendered. How do companies account for unearned revenues?

1. When the advance payment is received, Cash is debited, and a current liability account identifying the source of the unearned revenue is credited.
2. When the revenue is earned, the Unearned Revenue account is debited, and an earned revenue account is credited.

To illustrate, assume that Superior Catering sells a party for 10,000 people at $50 each for a Thanksgiving event. The entry for the sale looks like this:

A	=	L	+	SE
+500,000		+500,000		

Aug. 6	Cash	500,000	
	Unearned Catering Revenue		500,000

As the function is completed, the following entry is made:

Sept. 7	Unearned Revenue	500,000	
	Sales Revenue		500,000
	(To record revenues earned)		

A	=	L	+	SE
		−500,000		+500,000

Any balance in an unearned revenue account is reported as a current liability in the balance sheet. As revenue is earned, a transfer from unearned revenue to earned revenue occurs. Unearned revenue is material for some companies: In the airline industry, for example, tickets sold for future flights represent almost 50 percent of total current liabilities. At **United Air Lines**, unearned ticket revenue is the largest current liability, recently amounting to more than $1 billion.

Illustration 11-18 shows specific unearned and earned revenue accounts used in selected types of businesses.

Illustration 11-18

Unearned and earned revenue accounts

Type of Business	Account Title	
	Unearned Revenue	**Earned Revenue**
Airline	Unearned Passenger Ticket Revenue	Passenger Revenue
Magazine publisher	Unearned Subscription Revenue	Subscription Revenue
Hotel	Unearned Rental Revenue	Rental Revenue
Insurance company	Unearned Premium Revenue	Premium Revenue

CURRENT MATURITIES OF LONG-TERM DEBT

Companies often have a portion of long-term debt that comes due in the current year. That amount would be considered a current liability. For example, assume that Wendy Construction issues a five-year interest-bearing $25,000 note on January 1, 2004. Each January 1, starting January 1, 2005, $5,000 of the note is due to be paid. When financial statements are prepared on December 31, 2004, $5,000 should be reported as a current liability. The remaining $20,000 on the note would be reported as a long-term liability. Current maturities of long-term debt are often termed **long-term debt due within one year**.

It is not necessary to prepare an adjusting entry to recognize the current maturity of long-term debt. The proper statement classification of each balance sheet account is recognized when the balance sheet is prepared.

DEMONSTRATION PROBLEM

The following selected transactions relate to Falcetto Souvenirs Company.

Mar.	1	Sold $20,000 of merchandise to Potter Hotels, terms 2/10, n/30.
	11	Received payment in full from Potter Hotels for balance due.
	12	Accepted Juno Resorts $20,000, 6-month, 12% note for balance due.
	15	Made American Express credit sales totaling $6,700. A 5% service fee is charged by American Express.
	30	Received payment in full from American Express Company.
Apr.	11	Sold accounts receivable of $8,000 to Harcot Factor. Harcot Factor assesses a service charge of 2% of the amount of receivables sold.
May	10	Wrote off as uncollectible $16,000 of accounts receivable. Falcetto uses the percentage of sales basis to estimate bad debts.
June	30	Credit sales for the first 6 months total $2,000,000. The bad debt percentage is 1% of credit sales. At June 30, the balance in the allowance account is $3,500.
July	16	One of the accounts receivable written off in May was from J. Simon, who pays the amount due, $4,000, in full.

Instructions

Prepare the journal entries for the transactions.

ACTION PLAN

- Generally, record accounts receivable at invoice price.
- Recognize that sales returns and allowances and cash discounts reduce the amount received on accounts receivable.
- Record a service charge expense on the seller's books when accounts receivable are sold.
- Prepare an adjusting entry for bad debts expense.
- Ignore any balance in the allowance account under the percentage of sales basis. Recognize the balance in the allowance account under the percentage of receivables basis.
- Record write-offs of accounts receivable only in balance sheet accounts.

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SOLUTION TO DEMONSTRATION PROBLEM

Mar. 1	Accounts Receivable–Potter	20,000	
	Sales		20,000
	(To record sales on account)		
11	Cash	19,600	
	Sales Discounts (2% × $20,000)	400	
	Accounts Receivable—Potter		20,000
	(To record collection of accounts receivable)		
12	Notes Receivable	20,000	
	Accounts Receivable—Juno		20,000
	(To record acceptance of Juno Company note)		
15	Accounts Receivable—American Express	6,365	
	Service Charge Expense (5% × $6,700)	335	
	Sales		6,700
	(To record credit card sales)		
Mar. 30	Cash	6,365	
	Accounts Receivable—American Express		6,365
	(To record redemption of credit card billings)		
Apr. 11	Cash	7,840	
	Service Charge Expense (2% × $8,000)	160	
	Accounts Receivable		8,000
	(To record sale of receivables to factor)		
May 10	Allowance for Doubtful Accounts	16,000	
	Accounts Receivable		16,000
	(To record write-off of accounts receivable)		
June 30	Bad Debts Expense ($2,000,000 × 1%)	20,000	
	Allowance for Doubtful Accounts		20,000
	(To record estimate of uncollectible accounts)		
July 16	Accounts Receivable—J. Simon	4,000	
	Allowance for Doubtful Accounts		4,000
	(To reverse write-off of accounts receivable)		
16	Cash	4,000	
	Accounts Receivable—J. Simon		4,000
	(To record collection of accounts receivable)		

SUMMARY OF STUDY OBJECTIVES

1. *Identify the different types of receivables.* Receivables are frequently classified as (1) accounts, (2) notes, and (3) other. Accounts receivable are amounts owed by customers on account. Notes receivable are claims for which formal instruments of credit are issued as proof of the debt. Other receivables include nontrade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable.

2. *Explain how accounts receivable are recognized in the accounts.* Accounts receivable are recorded at invoice price. They are reduced by Sales Returns and Allowances. Cash discounts reduce the amount received on accounts receivable. When interest is charged on a past due receivable, this interest is added to the accounts receivable balance and is recognized as interest revenue.

3. *Distinguish between the methods and bases used to value accounts receivable.* There are two methods of accounting for uncollectible accounts: (1) the allowance method and (2) the direct write-off method. Either the percentage of sales or the percentage of receivables basis may be used to estimate uncollectible accounts using the allowance method. The percentage of sales basis emphasizes the matching principle. The percentage of receivables basis emphasizes the cash realizable value of the accounts receivable. An aging schedule is often used with this basis.

4. *Describe the entries to record the disposition of accounts receivable.* When an account receivable is collected, Accounts Receivable is credited. When an account receivable is sold, a service charge expense is charged which reduces the amount collected.

5. *Explain why credit policies are needed in the hospitality industry.* Credit policies are needed in the hospitality industry, especially in the hotel industry where functions and parties are held. Good credit policies will ensure guest satisfaction, lessen misunderstanding, and ensure that the hospitality business will be able to collect its revenues in a timely manner.

6. *Compute the maturity date of and interest on notes receivable.* The maturity date of a note must be computed unless the due date is specified or the note is payable on demand. For a note stated in months, the maturity date is found by counting the months from the date of issue. For a note stated in days, the number of days is counted, omitting the issue date and counting the due date. The formula for computing interest is face value × interest rate × time.

7. *Explain how notes receivable are recognized in the accounts.* Notes receivable are recorded at face value. In some cases, it is necessary to accrue interest prior to maturity. In this case, Interest Receivable is debited and Interest Revenue is credited.

8. *Describe how notes receivable are valued.* Like accounts receivable, notes receivable are reported at their cash (net) realizable value. The notes receivable allowance account is the Allowance for Doubtful Accounts. The computation and estimations involved in valuing notes receivable at cash realizable value, and in recording the proper amount of bad debts expense and related allowance are similar to those for accounts receivable.

9. *Describe the entries to record the disposition of notes receivable.* Notes can be held to maturity. At that time the face value plus accrued interest is due, and the note is removed from the accounts. In many cases, the holder of the note speeds up the conversion by selling the receivable to another party. In some situations, the maker of the note dishonors the note (defaults), and the note is written off.

10. *Explain a current liability, and identify the major types of current liabilities.* A current liability is a debt that can be reasonably expected to be paid (1) from existing current assets or through the creation of other current liabilities, and (2) within one year or the operating cycle, whichever is longer. The major types of current liabilities are notes payable, accounts payable, sales taxes payable, unearned revenues, and accrued liabilities such as taxes, salaries and wages, and interest payable.

11. *Describe the accounting of notes payable.* When a promissory note is interest bearing, the amount of assets received upon the issuance of the note is generally equal to the face value of the note. Interest expense is accrued over the life of the note. At maturity, the amount paid is equal to the face value of the note plus accrued interest.

12. *Explain the accounting for other current liabilities.* Sales taxes payable are recorded at the time the related sales occur. The company serves as a collection agent for the taxing authority. Sales taxes are not an expense to the company. Until employee withholding taxes are remitted to governmental taxing authorities, they are credited to appropriate liability accounts. Unearned revenues are initially recorded in an unearned revenue account. As the revenue is earned, a transfer from unearned revenue to earned revenue occurs. The current maturities of long-term debt should be reported as a current liability in the balance sheet.

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GLOSSARY

Accounts receivable Amounts owed by customers on account as a result from the sale of goods and services (p. 353).

Aging of accounts receivable The analysis of customer balances by the length of time they have been unpaid (p. 359).

Allowance method A method of accounting for bad debts that involves estimating uncollectible accounts at the end of each period (p. 355).

Bad Debts Expense An expense account to record uncollectible receivables (p. 354).

Cash (net) realizable value The net amount expected to be received in cash (p. 355).

Direct write-off method A method of accounting for bad debts that involves expensing accounts at the time they are determined to be uncollectible (p. 354).

Dishonored note A note that is not paid in full at maturity (p. 369).

Factor A finance company or bank that buys receivables from businesses and then collects the payments directly from the customers (p. 361).

Maker The party in a promissory note who is making the promise to pay (p. 365).

Notes payable Obligations in the form of written promissory notes (p. 371).

Notes receivable Claims for which formal instruments of credit are issued as evidence of the debt (p. 354).

Other receivables Nontrade receivables such as interest receivable, loan to company officers, advances to employees, and income tax refundable (p. 353).

Payee The party to whom payment of a promissory note is to be made (p. 365).

Percentage of receivables basis Management establishes a percentage relationship between the amount of receivables and the expected losses from uncollectible accounts (p. 358).

Percentage of sales basis Management establishes a percentage relationship between the amount of credit sales and expected losses from uncollectible accounts (p. 358).

Promissory note A written promise to pay a specified amount of money on demand or at a definite time (p. 365).

Trade receivables Notes and accounts receivable that result from sales transactions (p. 353).

EXERCISES

Identify different types of receivables. (SO 1)

11-1 Presented below are three receivables transactions. Indicate whether these receivables are reported as accounts receivable, notes receivable, or other receivables on a balance sheet.

(a) Sold merchandise on account for $70,000 to a customer.
(b) Received a promissory note of $57,000 for services performed.
(c) Advanced $10,000 to an employee.

Record basic accounts receivable transactions. (SO 2)

11-2 Record the following transactions on the books of Essex Golf Supplies.

(a) On July 1, Essex sold merchandise on account to Harrard Golf Club for $16,000, terms 2/10, n/30.
(b) On July 8, Harrard returned merchandise worth $3,800 to Essex Co.
(c) On July 11, Harrard paid for the merchandise.

Prepare entries for write-off; determine cash realizable value. (SO 3)

11-3 At the end of 2004, Searcy Hotel has accounts receivable of $700,000 and an allowance for doubtful accounts of $54,000. On January 24, 2005, the company learns that its receivable from Hunt Inc. is not collectible, and management authorizes a write-off of $7,000.

(a) Prepare the journal entry to record the write-off.
(b) What is the cash realizable value of the accounts receivable (1) before the write-off and (2) after the write-off?

Prepare entries for collection of bad debts write-off. (SO 3)

(c) On March 4, 2005, Searcy Hotel receives payment of $7,000 in full from Hunt Inc. Prepare the journal entries to record this transaction.

Compute interest and determine maturity dates on notes. (SO 6)

11-4 Compute interest and find the maturity date for the following notes.

	Date of Note	Principal	Interest Rate (%)	Terms
(a)	June 10	$100,000	9%	60 days
(b)	July 14	$ 50,000	$7\frac{1}{2}$%	90 days
(c)	April 27	$ 12,000	8%	75 days

Determine maturity dates and compute interest and rates on notes. (SO 6)

11-5 Presented below are data on three promissory notes. Determine the missing amounts.

	Date of Note	Terms	Maturity Date	Principal	Annual Interest Rate	Total Interest
(a)	April 1	60 days	?	$900,000	9%	?
(b)	July 2	30 days	?	90,000	?	$600
(c)	March 7	6 months	?	120,000	12%	?

Prepare entries to dispose of accounts receivable. (SO 4)

11-6 Presented below are two independent transactions.

(a) Raja Restaurant accepted a VISA card in payment of a $200 lunch bill. The bank charges a 3 percent fee. What entry should Raja make?
(b) Wendy Company sold its accounts receivable of $80,000. What entry should Wendy make, given a service charge of 3 percent on the amount of receivables sold?

Identify whether obligations are current liabilities. (SO 10)

11-7 Ceneplex Theatre has the following obligations at December 31: (a) a note payable for $100,000 due in two years, (b) a ten-year mortgage payable of $200,000 payable in ten $20,000 annual payments, (c) interest payable of $15,000 on the mortgage, and (d) accounts payable of $60,000. For each obligation, indicate whether it should be classified as a current liability.

Prepare entries for an interest-bearing note payable. (SO 11)

11-8 Banderas Spa borrows $60,000 on July 1 from the bank by signing a $60,000, 10 percent, one-year note payable. Prepare the journal entries to record (a) the proceeds of the note and (b) accrued interest at December 31, assuming adjusting entries are made only at the end of the year.

Compute and record sales taxes payable. (SO 12)

11-9 Jurassic Theme Park does not segregate sales and sales taxes at the time of sale. The register total for March 16 is $9,975. All sales are subject to a 5 percent sales tax. Compute sales taxes payable and make the entry to record sales taxes payable and sales.

Compute gross earnings and net pay. (SO 12)

11-10 Becky's Grill regular hourly wage rate is $14, and she receives an hourly rate of $21 for work in excess of 40 hours. During a January pay period, Becky works 45 hours. Becky's federal income tax withholding is $95, her FICA tax withheld is $53.20, and she has no voluntary deductions. Compute Becky Grill's gross earnings and net pay for the pay period.

11-11 Patillo Resort has accounts receivable of $97,500 at March 31. An analysis of the accounts shows the following.

Determine bad debts expense; prepare the adjusting entry for bad debts expense.
(SO 3)

Month of Sale	Balance, March 31
March	$65,000
February	17,600
January	8,500
Prior to January	6,400
	$97,500

Credit terms are 2/10, n/30. At March 31, Allowance for Doubtful Accounts has a credit balance of $1,600 prior to adjustment. The company uses the percentage of receivables basis for estimating uncollectible accounts. The company's estimate of bad debts is as follows:

Age of Accounts	Estimated Percentage Uncollectible
1–30 days	2.0%
31–60 days	5.0%
61–90 days	30.0%
Over 90 days	50.0%

Instructions

(a) Determine the total estimated uncollectibles.
(b) Prepare the adjusting entry at March 31 to record bad debts expense.

Journalize entries for notes receivable transactions.
(SO 6, 7)

11-12 Gore Food Supply Co. has the following transactions related to notes receivable during the last two months of the year.

Nov. 1 Loaned $18,000 cash to Sally Morgan Restaurant on a one-year, 10 percent note
Dec. 11 Sold goods to Adams BBQ receiving a $6,000, 90-day, 12 percent note
16 Received a $4,000, 180-day, 12% note on account from Prentice Bakery
31 Accrued interest revenue on all notes receivable

Instructions

Journalize the transactions for Gore Food Supply Co.

Journalize entries for notes receivable.
(SO 7, 8)

11-13 Record the following transactions for Icke Ice Co. in the general journal

2002

May 1 Received a $10,500, one-year, 10 percent note on account from Paul's Hamburger
Dec. 31 Accrued interest on the note
Dec. 31 Closed the interest revenue account

2003

May 1 Received principal plus interest on the note (No interest has been accrued in 2003.)

Journalize entries to record transactions related to bad debts.
(SO 2, 3)

11-14 Presented below is an aging schedule for Grifton Hotel.

Customer	Total	Not Yet Due	Number of Days Past Due 1–30	31–60	61–90	Over 90
Jones	$ 22,000		$10,000	$12,000		
Johnson	40,000	$ 40,000				
Klinger	57,000	16,000	6,000		$35,000	
Morgan	34,000					$34,000
Others	132,000	96,000	16,000	14,000		6,000
	$285,000	$152,000	$32,000	$26,000	$35,000	$40,000
Estimated Percentage Uncollectible		4%	7%	13%	25%	50%
Total Estimated Bad Debts	$ 40,450	$ 6,080	$ 2,240	$ 3,380	$ 8,750	$20,000

At December 31, 2004, the unadjusted balance in Allowance for Doubtful Accounts is a credit of $12,000.

Instructions

(a) Journalize and post the adjusting entry for bad debts at December 31, 2004.

(b) Journalize and post to the allowance account the following events and transactions in the year 2005.

(1) On March 31, a $1,000 customer balance originating in 2004 is judged uncollectible.

(2) On May 31, a check for $1,000 is received from the customer whose account was written off as uncollectible on March 31.

(c) Journalize the adjusting entry for bad debts on December 31, 2005, assuming that the unadjusted balance in Allowance for Doubtful Accounts is a debit of $800 and the aging schedule indicates that total estimated bad debts will be $30,300.

Journalize sales and related taxes.
(SO 12)

11-15 In providing accounting services to small businesses, you encounter the following situations pertaining to cash sales.

1. Cavanaugh Pizza rings up sales and sales taxes separately on its cash register. On April 10, the register totals are sales $25,000 and sales taxes $1,500.
2. Corelli Pasta does not segregate sales and sales taxes. Its register total for April 15 is $13,780, which includes a 6% sales tax.

Instructions

Prepare the entry to record the sales transactions and related taxes for each client.

EXPLORING THE WEB

11-16 ***Purpose:*** The Securities Exchange Act of 1934 requires any firm that is listed on one of the national exchanges to file annual reports (form 10-K), financial statements, and quarterly reports (form 10-Q) with the SEC. This exercise demonstrates how to search and access available SEC filings through the Internet.

Address: **http://biz.yahoo.com/i**

Steps

1. Type in a company's name, or use index to find a company name.
2. Choose **Profile**.
3. Choose **Raw SEC Filings**.

Instructions

Answer the following questions.

(a) Which SEC filings were available for the company you selected?

(b) In the company's quarterly report (SEC form 10-Q), what was one key point discussed in the "Management's Discussion and Analysis of Results of Operations and Financial Condition"?

(c) What was the net income for the period selected?

ETHICS CASE

11-17 The controller of Shirt Co. believes that the yearly allowance for doubtful accounts for Shirt Co. should be 2 percent of net credit sales. The president of Shirt Co., nervous that the stockholders might expect the company to sustain its 10 percent growth rate, suggests that the controller increase the allowance for doubtful accounts to 4 percent. The president thinks that the lower net income, which reflects a 6 percent growth rate, will be a more sustainable rate for Shirt Co.

Instructions

(a) Who are the stakeholders in this case?

(b) Does the president's request pose an ethical dilemma for the controller?

(c) Should the controller be concerned with Shirt Co.'s growth rate in estimating the allowance? Explain your answer.

Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.