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CMA REVIEW

PART 1: FINANCIAL PLANNING, PERFORMANCE, AND ANALYTICS

by

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and

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STUDY UNIT TWO

MEASUREMENT, VALUATION, AND DISCLOSURE: ASSETS -- SHORT-TERM ITEMS

(20 pages of outline)

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2.2	*Inventory -- Fundamentals*	*58*
2.3	*Inventory -- Cost Flow Methods*	*64*
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This study unit is the **second of six** on **external financial reporting decisions**. The relative weight assigned to this major topic in Part 1 of the exam is **15%**. The six study units are

Study Unit 1: External Financial Statements
Study Unit 2: Measurement, Valuation, and Disclosure: Assets -- Short-Term Items
Study Unit 3: Measurement, Valuation, and Disclosure: Assets -- Long-Term Items
Study Unit 4: Measurement, Valuation, and Disclosure: Liabilities
Study Unit 5: Revenue and Impairment Recognition
Study Unit 6: Integrated Reporting

If you are interested in reviewing more introductory or background material, go to www.gleim.com/CMAIntroVideos for a list of suggested third-party overviews of this topic. The following Gleim outline material is more than sufficient to help you pass the CMA exam. Any additional introductory or background material is for your personal enrichment.

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2.1 ACCOUNTS RECEIVABLE

1. **Overview**
   a. Accounts receivable **(trade receivables)** are amounts owed to an entity by its customers resulting from credit sales in the ordinary course of business that are due in customary trade terms.
      1) All other receivables are non-trade receivables.
   b. The recording of a receivable, which often coincides with revenue recognition, is consistent with the accrual method of accounting.
   c. Receivables should be separated into **current and noncurrent** portions. Most of the entity's accounts receivable are classified as current assets because they are expected to be collected within 1 year or the entity's normal operating cycle.
      1) **Current** accounts receivable are reported in the balance sheet at **net realizable value (NRV)**, i.e., net of allowance for credit losses (uncollectible accounts), allowance for sales returns, and billing adjustments.
      2) **Noncurrent** receivables are measured at net present value of future cash flows expected to be collected.
   d. The principal measurement issue for accounts receivable is the estimation of the **allowance for credit loss** and calculation of **credit loss expenses** for the period.
   e. The direct write-off method expenses bad debts when they are determined to be uncollectible.
      1) It is **not acceptable under GAAP** because it does not match revenue and expense when the receivable and the write-off are recorded in different periods.
      2) But this method is used for tax purposes.
2. **Allowance for Customers' Right of Sales Return**
   a. When a right of return exists, an entity may recognize revenue from a sale of goods at the time of sale only if the amount of future returns can be reliably estimated. A provision must be made for the return of merchandise because of product defects, customer dissatisfaction, etc.
   b. To be consistent with the **matching principle** (recognition of revenue and related expense in the same accounting period), the revenue from the sale of goods and the expense for the estimated sales returns must be recognized on the same date.
      1) Accordingly, an **allowance** for sales returns should be established.

EXAMPLE 2-1 Allowance for Sales Returns

A company has $500,000 of sales in July, its first month of operations. Management estimates that total returns will be 1% of sales.

<u>Recognition of revenue from sale</u>			<u>Recognition of allowance for sales returns</u>		
Cash/accounts receivable	$500,000		Sales returns (contra revenue)	$5,000	
Sales		$500,000	Allowance for sales returns (contra asset)		$5,000

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3. **Allowance Method (Required under GAAP)**

   a. The allowance method attempts to match **credit loss expense** with the **related revenue**. This method is **required under GAAP**.

      1) The periodic journal entry to record credit loss expense is

Credit loss expense	$XXX	
Allowance for credit losses		$XXX

      2) As specific accounts receivable are written off, they are charged to the allowance account.

Allowance for credit losses	$XXX	
Accounts receivable		$XXX

      3) Thus, the **write-off** of a particular account has no effect on expenses.

         a) Write-offs do not affect the carrying amount of the net accounts receivable balance because the reductions of gross accounts receivable and the allowance are the same.

      4) In the balance sheet, the carrying amount of accounts receivable is reported at the net amount expected to be collected.

Gross accounts receivable – **Allowance for credit losses** = **Carrying amount of accounts receivable**

   b. Under the allowance method, the two approaches to calculating the amount charged to credit loss expense are the income statement approach and the balance sheet approach.

AUTHOR'S NOTE

The direct write-off method (i.e., expense bad debts only when they are determined to be uncollectible) is **not acceptable under GAAP**. This method does not match revenues and expenses. Occasionally, a small company will use the direct write-off method under the assumption that the difference between it and the allowance method is immaterial. In other words, the materiality principle is used as an excuse to violate the matching principle.

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4. **Income Statement Approach (Percentage of Sales)**

   a. Under the income statement approach, the entity estimates the periodic credit loss expense as a percentage of sales on credit. The journal entry is

Credit loss expense	$XXX	
Allowance for credit losses		$XXX

   b. The ending balance of the allowance for credit losses is determined after all the activity in the allowance account is recorded during the period.

EXAMPLE 2-2 Income Statement Approach

Midburg Co. has the following unadjusted account balances at year end:

Cash	$ 85,000 Dr.
Accounts receivable	100,000 Dr.
Allowance for credit losses	2,000 Cr.
Sales on credit	500,000 Cr.

Based on its experience, Midburg expects credit losses to average 2% of credit sales. Thus, the estimated credit loss expense is $10,000 ($500,000 × 2%). The year-end adjusting entry is

Credit loss expense	$10,000	
Allowance for credit losses		$10,000

The year-end adjusted balance of allowance for credit losses is a $12,000 credit ($10,000 + $2,000).

Balance sheet presentation	
Accounts receivable	$100,000
(Allowance for credit losses)	(12,000)
Accounts receivable, net	$ 88,000

5. **Balance Sheet Approach (Percentage of Receivables)**

   a. Under this approach, the ending balance of the allowance for credit losses is a percentage of the ending balance of accounts receivable.

      1) Credit loss expense reflects the adjustment of the allowance to its correct ending balance.

EXAMPLE 2-3 Balance Sheet Approach

Using the data from Example 2-2, assume that, based on Midburg's experience, 6% of accounts receivable are determined to be uncollectible. Thus, the ending balance of the allowance for credit losses is $6,000 ($100,000 × 6%). Because the allowance currently has a balance of $2,000, the following journal entry is required:

Credit loss expense ($6,000 – $2,000)	$4,000	
Allowance for credit losses		$4,000

Balance sheet presentation	
Accounts receivable	$100,000
(Allowance for credit losses)	(6,000)
Accounts receivable, net	$ 94,000

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b. An entity rarely experiences a single rate of uncollectibility on all its accounts. For this reason, entities using the balance sheet approach to estimate expected credit losses for accounts receivable generally prepare an **aging schedule**.

EXAMPLE 2-4 Balance Sheet Approach with Aging Schedule

Midburg prepares the following aging schedule of its accounts receivable:

Balance Range	Less than 30 Days	31-60 Days	61-90 Days	Over 90 Days	Total Balances
$0 - $100	$ 5,000	$ 200	$ 100	$ 100	$ 5,400
$100 - $1,000	8,000	3,800			11,800
$1,000 - $5,000	20,000	2,000	1,900		23,900
$5,000 - $10,000	38,000		8,000	900	46,900
Over $10,000		12,000			12,000
Totals	$71,000	$18,000	$10,000	$1,000	$100,000

Midburg then applies an appropriate percentage to each stratum based on experience.

Aging Intervals	Balance	Estimated Uncollectible	Ending Allowance
Less than 30 days	$ 71,000	2%	$1,420
30-60 days	18,000	12%	2,160
61-90 days	10,000	15%	1,500
Over 90 days	1,000	20%	200
Total	$100,000		$5,280

Because the allowance currently has a balance of $2,000, the following journal entry is required to establish the proper measurement:

	Debit	Credit
Credit loss expense ($5,280 – $2,000)	$3,280	
Allowance for credit losses		$3,280

Balance sheet presentation	
Accounts receivable	$100,000
(Allowance for credit losses)	(5,280)
Accounts receivable, net	$ 94,720

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6. **Collection of Accounts Previously Written Off**

   a. Occasionally, a customer pays on an account previously written off.

Cash	$XXX	
Allowance for credit losses		$XXX

      1) Credit loss expense is not affected when an account receivable is written off or when an account previously written off becomes collectible.

   b. The following equation illustrates the reconciliation of the beginning and ending balances of gross accounts receivable (accounts receivable before adjustment for allowance for credit losses):

      Beginning accounts receivable
      + Credit sales during the period
      – Cash collected on credit sales during the period
      – Accounts receivable written-off during the period
      = Ending accounts receivable

   c. The following equation illustrates the reconciliation of the beginning and ending balances of the allowance for credit losses:

      Beginning allowance for credit losses
      + Credit loss expense recognized for the period
      – Accounts receivable written off
      + Collection of accounts receivable previously written off
      = Ending allowance for credit losses

      1) Under the **income statement approach**, credit loss expense is a percentage of sales on credit, and the ending balance of the allowance is calculated using the equation above.

      2) Under the **balance sheet approach**, the ending balance of the allowance is a percentage of the ending balance of accounts receivable, and credit loss expense is calculated using the equation above.

7. **Factoring of Accounts Receivable**

   a. **Factoring** is a transfer of receivables to a third party (a factor) who assumes the responsibility of collection.

   b. Factoring discounts receivables on a **nonrecourse**, notification basis. Thus, payments by the debtors on the transferred assets are made to the factor. If the transferor (seller) surrenders control, **the transaction is a sale**.

      1) If a sale is **without recourse**, the transferee (credit agency) assumes the risks and receives the rewards of collection. This sale is final, and the seller has no further liabilities to the transferee. Accordingly, the receivables are no longer reported on the seller's books.

      2) If a sale is **with recourse**, the transferor (seller) may be required to make payments to the transferee or to buy back receivables in specified circumstances.

         a) In this circumstance, the transfer might not qualify as a sale. The parties account for the transaction as a secured borrowing with a pledge of noncash collateral.

         b) Accordingly, the receivables are still on the seller's books and it must recognize a liability for the amount of cash received.

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EXAMPLE 2-5 Factoring of Accounts Receivable

A factor charges a 2% fee plus an interest rate of 18% on all cash advanced to a transferor of accounts receivable. Monthly sales are $100,000, and the factor advances 90% of the receivables submitted after deducting the 2% fee and the interest. Credit terms are net 60 days. What is the cost to the transferor of this arrangement?

Amount of receivables submitted	$100,000	
Minus: 10% reserve	(10,000)	
Minus: 2% factor's fee	(2,000)	
Amount accruing to the transferor	$ 88,000	
Minus: 18% interest for 60 days	(2,640)	[$88,000 × 18% × (60 ÷ 360)]
Amount to be received immediately	$ 85,360	

The transferor also will receive the $10,000 reserve at the end of the 60-day period if it has not been absorbed by sales returns and allowances. Thus, the total cost to the transferor to factor the receivables for the month is $4,640 ($2,000 factor fee + interest of $2,640). Assuming that the factor has approved the customers' credit in advance (the sale is without recourse), the transferor will not absorb any bad debts.

The journal entry to record the transaction is

Cash	$85,360	
Due from factor	10,000	
Loss on sale of receivables	2,000	
Prepaid interest	2,640	
Accounts receivable		$100,000

c. The main reasons for factoring transactions are as follows:

1) A factor usually receives a high financing fee plus a fee for collection. Furthermore, the factor often operates more efficiently than its clients because of the specialized nature of its services.

2) An entity (seller) that uses a factor tries to speed up its collections. Also, it can eliminate its credit department and accounts receivable staff. In addition, bad debts are eliminated from the financial statements.

a) These reductions in costs can offset the fee charged by the factor.

d. Credit card sales are a common form of factoring. The retailer benefits by prompt receipt of cash and avoidance of bad debts and other costs. In return, the credit card company charges a fee.

STOP & REVIEW

You have completed the outline for this subunit.
Study multiple-choice questions 1 through 5 beginning on page 71.

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