

I. A Few Comments

- A. We will cover the notes payable section when we to Chapter Six at the end of the semester.
- B. Accounts receivable is a good example of two major aspects of internal accounting controls:
 - 1. First establish existence of an asset, then determine valuation – this is also an audit concept. **Q7**.
 - 2. Periodically reconcile controls accounts to supporting detail: here it is the A/R aged trial balance.
- C. There a number of types of receivables; however, trade receivables is generally the most important.

II. Review of the Sales Cycle

- A. We can apply three of the four accounting principles to the sales cycle:
 - 1. Revenue recognition – when do we recognize the receivable and for how much?
 - 2. Matching principle – matching bad debt expense to the period in which the sales were made.
 - 3. Full disclosure – we disclose both the total receivables, the allowance for doubtful accounts and the changes in the doubtful accounts.

III. We have sold \$20,000 of product to Li Manufacturing Corporation. We then collect the balance in three weeks time. What are the entries?

IV. Allowance for Doubtful Accounts and Bad Debt Expense – Valuation of the Accounts Receivable

A. Two methods

- 1. Direct write-off method, sometime called the specific identification method. It is like the cash-basis of accounting and does not match revenue with bad-debt expense.
- 2. Allowance method – two way to calculate the allowance – **BE 7-4, BE 7-5, E 7-7**
 - a. Income statement approach – percentage of sales: explicitly uses the matching principle.
 - b. Balance sheet approach – percentage of receivables: based on net-realizable value. Generally this is done with the use of an aged trail balance (see page 324).
- 3. Accounting for write-off a balance and the accounting for the recovery of the balance. **E- 7-8**

V. Terms

- 1. Sales discounts: for example 2/10/net 30 **BE 7-2, 7-3**
- 2. Trade discounts
- 3. Net realizable value
- 4. Nontrade receivables

VI. Financial Aspect of Accounts Receivable

- A. AR turnover and AR days Credit Sales/Average AR Balance then 365 days/AR turnover

- B. AR as collateral for borrowing – generally for a working capital line-of-credit **Q 16**

- C. Sales of AR
 - 1. With and without recourse
 - a. Recourse obligation
 - b. Example - 335
 - 2. Securitization – the portfolio effect

VII. Financial Statement Disclosure

- 1. If “pledged” for borrowings then the terms need to be disclosed in the notes to the financial statements.
- 2. Footnote disclosure:

Allowance for Doubtful Accounts

HP recognizes allowance for doubtful accounts to ensure trade and financing receivables are not overstated due to uncollectibility. Bad debt reserves are maintained for all customers based on a variety of factors, including the length of time receivables are past due, trends in overall weighted average risk rating of the total portfolio, macroeconomic conditions, significant one-time events and historical experience. An additional reserve for individual accounts is recorded when HP becomes aware of a customer's inability to meet its financial obligations, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position. If circumstances related to customers change, estimates of the recoverability of receivables would be further adjusted.

Concentrations of Credit Risk - see footnote 21 on page 337

Financial instruments that potentially subject HP to significant concentrations of credit risk consist principally of cash, investments, accounts receivable, financing receivables and derivatives. HP sells a significant portion of its products through third-party distributors and resellers and, as a result, maintains individually significant receivable balances with these parties. If the financial condition or operations of these distributors and resellers deteriorate substantially, HP's operating results could be adversely affected. **The ten largest distributor and reseller receivable balances collectively represented 21% of total accounts receivable at October 31, 2003 and 22% at October 31, 2002 and no single customer accounts for more than 10% of total accounts receivable.** Credit risk with respect to other accounts receivable and financing receivables is generally diversified due to the large number of entities comprising HP's customer base and their dispersion across many different industries and geographical regions. HP performs ongoing credit evaluations of the financial condition of its third-party distributors, resellers and other customers and requires collateral, such as letters of credit and bank guarantees, in certain circumstances. HP generally has experienced longer accounts receivable collection cycles in its emerging markets, in particular Asia-Pacific and Latin America, when compared to its United States and European markets. In the event that accounts receivable collection cycles in these developing markets significantly deteriorate or one or more of HP's larger resellers in these regions fail, HP's operating results could be adversely affected.

HEWLETT-PACKARD COMPANY AND SUBSIDIARIES - Valuation and Qualifying Accounts 10-31-2003

Allowance for doubtful accounts—accounts receivable:

Balance, beginning of period	410
Additions to allowance	29
Deductions, net of recoveries	(92)
Balance, end of period	347