Ch06 - Solutions to Suggested End-of-Chapter Material

Financial Accounting (Concordia University)

Chapter 6 – Solutions to Suggested End-of-Chapter Material

Questions

4. A sales discount is a discount given to customers for payment of accounts within a specified short period of time. Sales discounts arise only when goods are sold on credit and the seller extends credit terms that provide for a cash discount. For example, the credit terms may be 1/10, n/30. These terms mean that if the customer pays within 10 days, 1% can be deducted from the invoice price of the goods. Alternatively, if payment is not made within the 10-day period, no discount is permitted and the total invoice amount is due within 30 days from the purchase, after which the debt is past due. To illustrate, assuming a $1,000 sale with these terms, if the customer pays within 10 days, $990 would have been paid. Thus, a sales discount of $10 was granted for early payment.

5. A sales allowance is an amount allowed to a customer for unsatisfactory merchandise. A sales allowance reduces the amount the customer must pay, or if already paid, a cash refund is required. Sales allowances may occur whether the sale was for cash or credit. In contrast, a sales discount is a cash discount given to a customer who has bought on credit and made payment within the specified period. (Refer to explanation of sales discount in Question 4 above.)

9. The write-off of bad debts using the allowance method decreases the asset accounts receivable and the contra asset allowance for doubtful accounts by the same amount. Consequently, (a) net earnings are unaffected and (b) accounts receivable, net, is unaffected.

13. Accounts receivable cannot be considered cash equivalents. They are normally collected within three months and therefore meet part of the definition of cash equivalents. However, they are not readily convertible to cash as the conversion to cash depends on the actions of others (e.g., the customer) and there may be a significant amount of risk that the value will change in that the collection may not be assured.

15. The purposes of a bank reconciliation are (a) to determine the "true" cash balance, (b) to provide data to adjust the Cash account to that balance, and (c) to provide control over the cash account through independent verification. A bank reconciliation involves reconciling the balance in the Cash account at the end of the period with the balance shown on the bank statement (which is not the "true" cash balance) at the end of that same period. Seldom will these two balances be identical because of timing differences such as deposits in transit; that is deposits that have been made by the company but not yet entered on the bank statement, and outstanding cheques, which are cheques that have been written and recorded in the accounts of the company but have not cleared the bank, and hence they have not been deducted from the bank's balance. Usually, the reconciliation of the two balances, per books against per bank, requires recording of one or more items that are reflected on the bank statement but have not been recorded in the accounting records of the company. An example is the usual bank service charge, which is included on the bank statement, but has not yet been recorded in the company's books.

Exercises

E6–3

Req. 1

Sales revenue ($850 + $700 + $450)	$ 2,000
Less: Sales discount ($850 collected from S. Green x 2%)	17
Net sales	$1,983

Req. 2

Jan. 6	Accounts receivable – S. Green (+A)	850	
	Sales revenue (+R → +SE)		850
	Accounts receivable – M. Munoz (+A)	700	
	Sales revenue (+R → +SE)		700
Jan 14	Cash (+A) ($850 x 98%)	833	
	Sales discounts (XR → –SE) ($850 x 2%)	17	
	Accounts receivable – S. Green (-A)		850

E6-5

Req. 1

2020

November 20:

Cash (+A)	441	
Credit card discount (+XR→ –SE)	9	
Sales revenue (+R→ +SE)		450
To record credit card sale.		

November 25:

Accounts receivable – Customer Christine (+A)	2,800	
Sales revenue (+R→ +SE)		2,800
To record a credit sale.		

November 28:

Accounts receivable – Customer Daoud (+A)	7,200	
Sales revenue (+R→ +SE)		7,200
To record a credit sale.		

November 30:

Sales returns and allowances (+XR→ –SE)	600	
Accounts receivable – Customer Daoud (–A)		600
To record return of defective goods $7,200 x 1/12 = $600.		

December 6:

Cash (+A)	6,468	
Sales discounts (+XR→ –SE)	132	
Accounts receivable – Customer Daoud (–A)		6,600
To record collection within the discount period, 0.98 × ($7,200 – $600) = $6,468		

December 30:

Cash (+A)	2,800	
Accounts receivable – Customer Christine (–A)		2,800
To record collection after the discount period.		

Req. 2

Sales revenue ($450 + $2,800 + $7,200)	$10,450
Less: Sales returns and allowances	(600)
Sales discounts	(132)
Credit card discounts	(9)
Net sales	$ 9,709

E6–14

Req. 1 (amounts in millions of Swiss francs, CHF):

Dec. 31, current year

Allowance for doubtful accounts (–XA→ +A)................................	21	
Accounts receivable (–A)		21
To write off accounts receivable determined to be uncollectible.		
Accounts receivable (+A)	1	
Allowance for doubtful accounts (+XA→ –A).....................		1
To reinstate the receivable from various customers.		
Cash (+A)	1	
Accounts receivable (–A)		1
To record collection from various customers.		
Bad debt expense (+E→ –SE)	23.02	
Allowance for doubtful accounts (+XA → −A)....................		23.02
To record estimated bad debt expense.		

Aged Accounts receivable			Estimated percentage uncollectible		Estimated amount uncollectible
Not past due	CHF890	x	1%*	=	CHF 8.90
Past due 1–30 days	63	x	2.5%	=	1.58
Past due 31–60 days	8	x	25%	=	2.00
Past due 61–90 days	10	x	35%	=	3.50
Past due 91–120 days	1.2	x	50%	=	0.60
Past due more than 120 days	6.8	x	80%	=	5.44
Estimated ending balance in Allowance for Doubtful Accounts					CHF22.02
Unadjusted balance (19 – 21 + 1)					Debit 1.00
Bad debt expense for the current year					CHF23.02

**** The percentage 0.01 percent at the top of page 341 of E6-14 in the book should be 1 percent.***

Req. 2

Statement of financial position (amounts in millions of Swiss francs, CHF):

Current assets

Accounts receivable	CHF 979.00
Less: Allowance for doubtful accounts	22.02
Accounts receivable, net..	CHF 956.98

E6–15

(Journal entry amounts are in millions of Euro)

Req. 1

Bad debt expense (+E→ –SE)	63	
Allowance for doubtful accounts (+XA → −A)...............		63
To record estimated bad debt expense.		
Allowance for doubtful accounts (–XA → +A)...........................	107	
Accounts receivable (–A)...		107
To write off specific bad debts.		

Req. 2

It would have no effect because the asset "Accounts receivable" and contra-asset "Allowance for doubtful accounts" would both decrease by €10 million. Neither "net receivables" nor "net earnings" would be affected.

E6–18

Req. 1

The allowance for uncollectible accounts is increased (credited) when bad debt expense is recorded and decreased (debited) when uncollectible accounts are written off. This case gives the beginning and ending balances of the allowance account and the amount of uncollectible accounts that were written off. Therefore, the amount of bad debt expense can be computed as follows (amounts in millions):

Allowance for Uncollectible Accounts

(c)	56	(a)	70
		(d)	$\boxed{28}$
		(b)	42

(a) Beginning balance, given
(b) Ending balance, given
(c) Uncollectible accounts write-off, given
(d) Bad debt expense, inferred amount (to balance)

Req. 2

Working capital is unaffected by the write-off of an uncollectible account when the allowance method is used. The asset account (Accounts receivable) and the contra-asset account (Allowance for Uncollectible Accounts) are both reduced by the same amount; therefore, the net accounts receivable is unchanged.

Working capital is decreased when bad debt expense is recorded because the contra–asset account (Allowance for Uncollectible Accounts) is increased. From requirement (1), we know that net accounts receivable were reduced by $28 million when bad debt expense was recorded in year 2.

Note that earnings before taxes were reduced by the amount of bad debt expense that was recorded, therefore Income Tax Expense and Income Tax Payable will decrease. The decrease in Income Tax Payable caused working capital to increase; accordingly, the net decrease in working capital was $19.6 million (= $28 million – $28 million x 30%).

Req. 3

The entry to record the write-off of an uncollectible account did not affect any statement of earnings accounts; therefore, net earnings is unaffected by the $56 million write-off during year 2.

The recording of bad debt expense reduced earnings before taxes in Year 2 by $28 million and reduced tax expense by $8.4 million (i.e., $28 million x 30%). Therefore, Year 2 net earnings were reduced by $19.6 million (as computed in Req. 2).

E6–20

Req. 1

Calculations for Current Year:

$$\text{Receivables turnover} = \frac{\text{Net Sales}}{\text{Average Net Accounts Receivable}} = \frac{\$243{,}771{,}415}{\$35{,}437{,}151.5^*} = 6.9 \text{ times}$$

*[(34,592,365 – 666,528) + (38,212,947 – 1,264,481) ÷ 2

$$\text{Average age of receivables} = \frac{365}{\text{Receivables Turnover}} = \frac{365}{6.9} = 53 \text{ days (rounded)}$$

Req. 2

The receivables turnover ratio reflects how many times accounts receivable were recorded and collected, on average, during the period. The average collection period indicates the average time it takes a customer to pay the amount due.

E6–27

Req. 1

ZOLTAN COMPANY
Bank Reconciliation, June 30, 2020

Company's Books		*Bank Statement*	
Ending balance per Cash account ($6,900 + $18,100 – $19,000)………..	$6,000	Ending balance per bank statement ……………………………	$6,060
Additions:		**Additions:**	
None		Deposit in transit……………………	1,900*
			7,960
Deductions:		**Deductions:**	
Bank service charge………………	40	Outstanding cheques…………..	2,000
Ending correct cash balance	$5,960	Ending correct cash balance	$5,960

*$18,100 – $16,200 = $1,900.

Req. 2

Bank service charge expense (+E→ –SE)..	40	
Cash (–A)...		40
To record deduction from bank account for service charges.		

Req. 3

The balance in the Cash account after the above entry has been posted is the same as the correct cash balance per the bank reconciliation; $5,960.

Req. 4

Statement of financial position (June 30, 2020):
Current assets:
Cash ($5,960 + $300) $6,260

E6–29

Req. 1

Mini Mart Corporation
Bank Reconciliation
June 30

Cash balance per bank			$1,330
Add:	(1) Deposit in transit		160
			1,490
Less:	(2) Outstanding cheques		(240)
Adjusted cash balance per bank			$1,250
Cash balance per books			$ 499
Add:	(4) Note collected by bank and interest $40		840
			1,339
Less:	(3) Bank service charge	$ (9)	
	(5) NSF Cheque	(80)	(89)
Adjusted cash balance per books			$1,250

Req. 2

(1)	Cash (+A)	840	
	Notes receivable (–A)		800
	Interest revenue (+R→ +SE)		40
	Note receivable and interest collected. (This entry assumes that no previous entry was made to accrue interest revenue.)		
(2)	Accounts receivable (+A)	80	
	Cash (–A)		80
	Customer's cheque returned; insufficient funds.		
(3)	Bank service charge expense (+E→ –SE)	9	
	Cash (–A)		9
	Bank service charges deducted from bank statement.		

Req. 3

Preparation of a bank reconciliation is important for three reasons: (a) to determine the "true" cash balance, (b) to provide data to adjust the Cash account to that balance, and (c) to provide control over the cash account through independent verification.

Req. 4

The amount of cash that should be reported on the statement of financial position is $1,250.

Problems

P6–6

Req. 1

April 10	No journal entry as there is no exchange yet.		
April 30	Accounts receivable (+A)	150,000	
	Sales revenue (+R → +SE)		150,000
	Sold 15 machines to Yuri Inc.		
May 1	Accounts receivable (+A)	120,000	
	Sales revenue (+R → +SE)		120,000
	Sold 12 machines to Peter's Applicances.		
May 5	Cash (+A)	147,000	
	Sales discounts (+XR→ –R) [$150,000 x 2%]	3,000	
	Accounts receivable (–A)		150,000
	Collected from Yuri Inc. within the discount period.		
May 7	Accounts receivable (+A)	100,000	
	Sales revenue (+R → +SE)		100,000
	Sold 10 machines to Cheng Ltd.		
May 10	Allowance for doubtful accounts (–XA → +A)	12,000	
	Accounts receivable (–A)		12,000
	Write off of uncollectible accounts.		
May 15	Cash (+A)	100,000	
	Sales allowances and returns (+XR → –R)	20,000	
	Accounts receivable (–A)		120,000
	Peter's Appliances returned two machines and paid the amount due.		
June 1	Cash (+A)	80,000	
	Accounts receivable (–A)		80,000
	Collection from Cheng Ltd. on account.		
June 30	Accounts receivable (+A)	3,000	
	Allowance for doubtful accounts (+XA → –A)		3,000
	Reinstatement of accounts written off on May 10.		
	Cash (+A)	3,000	
	Accounts receivable (–A)		3,000
	Collection on accounts written off on May 10.		

P6–6 (continued)

Req. 2

The following time line shows the various transactions related to accounts receivable and helps in preparing the aging of accounts receivable schedule.

March 31	April 30	May 1	May 5	May 7	May 10	May 15	June 1	June 30
$60,000	$150,000	$120,000	($150,000)	$100,000	($12,000)	($20,000) ($100,000)	($80,000)	$3,000 ($3,000)
Balance	Yuri	Peter	Yuri	Cheng	Write-off	Peter	Cheng	Recovery

Age Group	Amount Receivable	Estimated Percent Uncollectible	**Estimated Uncollectible**
Not yet due	$ 0	5%	$ 0
1–30 days past due [$100,000 – $80,000]	20,000	10%	2,000
31–60 days past due	0	15%	0
More than 60 days past due	48,000*	20%	9,600
Total	$68,000		$11,600

* $60,000 (beginning balance) – $12,000 (write off)

Allowance for Doubtful Accounts

		Beg. bal.	15,000
Write-offs	12,000	Recoveries	3,000
		Bad debt exp.	$\boxed{5,600}$
		End. bal.	11,600

Adjusting entry:

June 30	Bad debt expense (+E → –SE)	5,600	
	Allowance for doubtful accounts (+XA → –A)................		5,600
	Recording of estimated bad debt expense for the period.		

Req. 3

Receivables turnover ratio = Net credit sales / Average net accounts receivable

Net credit sales = Credit sales – Sales discounts – Sales returns and allowances

P6–6 (continued)

The T-accounts below show the balances of effects of transcations on sales and accounts receivable

Sales

		Balance, March 31	600,000
		April 30	150,000
		May 1	120,000
		May 7	100,000
		Balance, June 30	970,000

Accounts Receivable

Balance, March 31	60,000		
April 30	150,000	May 5	150,000
May 1	120,000	May 10	12,000
May 7	100,000	May 15	120,000
June 30	3,000	June 1	80,000
		June 30	3,000
Balance, June 30	68,000		

Net credit sales = \$970,000 – \$3,000 – \$20,000 = \$947,000

Receivables turnover ratio =\$947,000/[\$80,000 + (\$68,000 – \$11,600)/2]

= \$947,000/\$68,200 = 13.89

Average collection period = 365/Receivables turnover ratio = 365/13.89 = 26.3 days

The average collection period reflects the average time it takes a customer to pay the amount due. In this case, the calculation suggests that it takes IceKreme's customers on average 26.3 days to pay the amount due.

Req. 4

IceKreme's customers pay, on average, after 26 days after the purchase date, which is within the credit of 30 days . They are paying off the amounts due faster than Pino's customers, but slower than Julia's customers.

P6–7

Req. 1

Dec. 5	Cash (+A)	19,000	
	Accounts receivable (+A)	48,000	
	Sales revenue (+R → +SE)		67,000
	Sale of merchandise, partly cash and the rest on account, terms 2/10, n/30.		
	Cost of sales (+E → –SE)	35,000	
	Merchandise inventory (–A)		35,000
	Cost of inventory sold.		
Dec. 12	Cash (+A)	23,520	
	Sales discounts (+XR → –R) [$24,000 x 2%]	480	
	Accounts receivable (–A)		24,000
	Collected cash for half the credit sales of Dec. 5.		
Dec. 20	Cash (+A)	90,000	
	Accounts receivable (–A)		90,000
	Collection on sales made in November.		
Dec. 26	Allowance for doubtful accounts (–XA → +A)	3,000	
	Accounts receivable (–A)		3,000
	Write off of a customer's uncollectibe account.		

Req. 2

Age Group	Amount Receivable	Estimated Percent Uncollectible	**Estimated Uncollectible**
Current	$42,000	1%	$420
1–30 days past due	31,500	2%	630
31–60 days past due	5,000	10%	500
More than 60 days past due	6,500	30%	1,950
Total	$85,000		$3,500

The amount of bad debt expense is the difference in the balance of the Allowance for Doubtful Accounts before and after the adjustment.

Bad debt expense = $3,500 – ($4,500 – $3,000) = $3,500 – $1,500 = $2,000

P6–7 (continued)

Adjusting entry:

Dec. 31	Bad debt expense (+E → –SE)	2,000	
	Allowance for doubtful accounts (+XA → –A)		2,000
	Recording of estimated bad debt expense for the period.		

Req. 3

Gross profit percentage = Gross Profit / Net Sales
= (Sales – Sales discount – COS) / (Sales – Sales discount)
= ($67,000 – $480 – $35,000) / ($67,000 – $480)
= $31,520 / $66,520 = 47.38%

This ratio measures how much gross profit is generated from every sales dollar. It reflects the ability to charge premium prices and purchase or produce goods and services at low cost.

Receivables turnover ratio = Net credit sales / Average net accounts receivable
= $47,520*/ $115,500** = 0.41 times (for December only)

* Net credit sales = Credit sales – Sales discount = $48,000 – $480 = $47,520

** Average net accounts receivable = Average of beginning and ending values of net receivables
=[($154,000 – $4,500) + ($85,000 – $3,500)]/2 = $115,500

This ratio measures how many times trade accounts receivable are recorded and collected during the period. This monthly ratio corresponds to an annual ratio of 4.92 (0.41 x 12), assuming that the sales and collection activities are typical monthly activities.

P6–8

Req. 1

The beginning balance of accounts receivable will increase by the amount of credit sales, and will decrease when cash is collected from customers or when accounts are written off as uncollectible. Accordingly, the balance of accounts receivable at December 31, 2021 is determined as follows:

Beginning balance	$ 500,000
+ Credit sales	1,000,000
– Collections from customers	(1,100,000)
– Write-off of uncollectible accounts	(30,000)
Ending balance	$ 370,000

Req. 2

Allowance for doubtful accounts (–XA → +A)........................	30,000	
Accounts receivable (–A)...		30,000

To record the write-off of accounts receivable as uncollectible.

Bad debt expense (+E → –SE)	27,200	
Allowance for doubtful accounts (+XA → –A)		27,200

To adjust the balance of the allowance for doubtful accounts and record bad debt expense for the year.

Ending balance of allowance account = $370,000 x 6% =	$22,200 Cr
Unadjusted balance of the allowance account ($25,000 – $30,000) =	5,000 Dr
Adjustment needed =	$27,200 Cr

Req. 3

Vital Inc.
Partial Statement of Financial Position
As at December 31, 2021

Current Assets	
....	
Accounts receivable	$370,000
Less: Allowance for doubtful accounts	(22,200)
Net	$347,800

OR

Accounts receivable (net of allowance of $22,200)	$347,800

P6–8 (continued)

Req. 4

The method being proposed by the bookkeeper is called the direct write-off method. The reasoning of the bookkeeper is quite appealing in the sense that it saves him and others time and effort in estimating the amount of receivables that may not be collected in the future. This simplistic approach would be acceptable if the amounts that are written off annually are relatively small or if they are close to the amount that would be considered uncollectible under the allowance method.

The main deficiency of the direct write-off method is its inconsistency with the matching process, which requires that expenses be matched to the related revenues during the same period. If an account receivable is written-off in a period that follows the period of sale, then the matching process would have not been observed. The direct method also results in an overstatement of accounts receivable, which should be reported at their estimated realizable value. Because most businesses have some amounts that will not be collected, a provision for uncollectible accounts should be made. For this reason, accountants estimate the amount that may not be collectible in the future, with full knowledge that the estimated amount may not be an exact amount. However, the estimated bad debt expense complies with the matching process. In that respect, it is preferable to be imprecisely right than precisely wrong.

P6–9

Req. 1

BUILDERS COMPANY INC.
Statement of Earnings
For the Year Ended December 31, 2020

Gross sales revenue		$145,600
Less: Sales discounts		6,400
Sales returns and allowances		5,600
Net sales revenue		133,600
Cost of sales		78,400
Gross profit		55,200
Operating expenses:		
Selling expenses	$13,600	
Administrative expenses	14,400	
Bad debt expense	1,600	29,600
Earnings before income tax		25,600
Income tax expense		7,680
Net earnings		$ 17,920

Earnings per share: ($17,920 ÷ 10,000 shares) $1.79

In this case earnings from operations is the same as earnings before income tax.

Req. 2

$$\text{Gross Profit Percentage} = \frac{\text{Gross Profit}}{\text{Net Sales}} = \frac{\$55,200}{\$133,600} = 0.41\ (41\%)$$

The gross profit percentage shows the excess of sales prices over the costs to purchase or produce the goods or services sold, measured as a percentage.

$$\text{Accounts Receivable Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Net Accounts Receivable}} = \frac{\$133,600}{\$15,200} = 8.79$$

Average net accounts receivable = ($16,000 + $14,400) ÷ 2

The accounts receivable turnover ratio reflects how many times accounts receivable were both recorded and collected, on average, during the time period. The higher the result is, the faster the collection of receivables.

Cases and Projects

CP6–1

Req. 1

The Company discloses its revenue recognition policy in Note 2 – Significant Accounting Policies. METRO's sales "come essentially from the sale of goods. Retail sales made by corporate stores and stores that are structured entities are recognized at the time of sale to the customer, and sales to affiliated stores and other customers when the goods are delivered."

Req. 2

Gross profit percentage = Gross profit / Net sales
2018: $2,826.9 ÷ $14,383.4 = 0.197 (19.7%)
2017: $2,595.7 ÷ $13,175.3 = 0.197 (19.7%)

METRO's gross profit percentage was the same in both years. The Company maintained its mark-up on the cost of merchandise it purchased for resale to customers.

Req. 3

The Company discusses credit risk in Note 28 – Financial Instruments, but did not disclose any details about an allowance for doubtful accounts, presumably because the balance of that account is not material.

Req. 4 (in millions of dollars)

$$\text{Receivables turnover} = \frac{\text{Net Sales}}{\text{Average Net Accounts Receivable}} = \frac{\$14{,}383.4}{425.9^*} = 33.77 \text{ times}$$

* ($313.7 + $538.1) ÷ 2

The receivables turnover for Gildan is 10.38. METRO's ratio is much higher than Gildan's because of the nature of the products it sells, its credit policy, and the speed of collection from customers. Another possible difference is the amount of credit sales for each company. The computation of the ratio assumes that all sales are on credit, but this may not be true.

Req. 5

According to Note 2 to its financial statements, METRO defines cash and cash equivalents as consisting of "… cash on hand, bank balances, highly liquid investments (with an initial term of three months or less) and outstanding deposits." Because cash and cash equivalents are essentially cash, the fair market value is extremely close to the disclosed amount.

CP6–5

Canadian banks usually have fiscal years that end on October 31.

Req. 1 and 2 (millions of dollars)

Fiscal year 2018

	Royal Bank of Canada	Bank of Nova Scotia	Canadian Imperial Bank of Commerce
a. Provision for credit losses	$ 1,307	$ 2,611	$ 870
b. Net interest income	18,191	16,191	10,065
Ratio a/b	7.18%	16.13%	8.64%

Fiscal year 2017

	Royal Bank of Canada	Bank of Nova Scotia	Canadian Imperial Bank of Commerce
a. Provision for credit losses	$ 1,150	$ 2,249	$ 829
b. Net interest income	17,140	15,035	8,977
Ratio a/b	6.71%	14.96%	9.23%

The Bank of Nova Scotia has the highest ratio of the three banks in both years. Notice that Bank of Nova Scotia's ratio for 2018 increased by 1.17% over its 2017 level and the ratio for Royal Bank increased by 0.47% while the ratio for CIBC decreased by 0.59% during the same year. Weaker economic conditions could explain an increase in the ratio.

Req. 3 and 4 (millions of dollars)

Fiscal year 2018

	Royal Bank of Canada	Bank of Nova Scotia	Canadian Imperial Bank of Commerce
a. Allowance for credit losses	$2,912	$5,065	$1,639
b. Total loans receivable	579,730	556,899	373,035
Ratio a/b	0.50%	0.91%	0.44%

Fiscal year 2017

	Royal Bank of Canada	Bank of Nova Scotia	Canadian Imperial Bank of Commerce
a. Allowance for credit losses	$2,159	$4,327	$1,618
b. Total loans receivable	544,776	508,696	358,332
Ratio a/b	0.48%	0.85%	0.45%

Banks lend money to a variety of customers, and classify their loans receivable according to the following main categories: residential mortgages, personal and credit card loans, and business and government loans. The quality of the bank's loans portfolio depends on the financial health of the individuals and companies that borrow money from the bank. Based on the ratios above, it appears that Bank of Nova Scotia risked losing $0.91 for every $100 it has lent to others as at October 31, 2018 whereas Canadian Imperial Bank of Commerce had a better quality loan portfolio than the other two banks as it risked losing a smaller percentage of its loans to customers.

The ratio increased for Bank of Nova Scotia and Royal Bank of Canada in 2018 compared to the previous year while it decreased for the Canadian Imperial Bank of Commerce during the same period.

<u>CRITICAL THINKING CASES</u>

CP6–6

Req. 1

The auditor was concerned because of the sequence of events as follows:

(a) The opening of a new account receivable of $2,500 (an unusually large amount and a "new" customer).

(b) The write-off of bad debts at year-end rather than during the year.

(c) The nearness of the creation of the new account receivable of $2,500 to the write-offs of three accounts of regular customers for a sum of $2,500.

(d) The accounts written off were for "regular" credit customers (Jones, Blake, and Sellers). Therefore, it is questionable why they would default on payment.

The sequence of events appears to have been:

i. At completion of the job, $2,500 was collected in cash from the new customer and pocketed by the clerk-bookkeeper.

ii. To cover the theft, and yet provide a record of the transaction, a fictitious account receivable was debited for the $2,500, instead of Cash.

CP6–6 *(continued)*

iii. When the three regular customers paid their accounts, Cash was debited for a total of $2,500 and the fictitious account receivable credited for the same amount. The regular customers' accounts were credited as bad debts so that they would neither be billed nor have reason to call attention to incorrect balances. All the bookkeeper had to do was find one account, or a combination of account balances, to write off a total of $2,500. This was done: $800 + $750 + $950 = $2,500.

The auditor has a professional responsibility to report these concerns and findings to the owner.

Req. 2

Recommendations:

(a) Report the circumstances to the owner. Do not recommend in respect to the clerk-bookkeeper; the owner must make the personnel decisions involved.

(b) Recommendations on internal control measures:
   (1) Separate cash-handling function from the related recordkeeping function.
   (2) Establish a definite routine for handling cash receipts.
   (3) Deposit all cash receipts intact each day.
   (4) Make all payments (except for cash on hand payments) by cheque. Require that supporting documents be attached to each cheque before signing. Designate all such documents as PAID, i.e., cancelled, when the cheque is signed (this will help prevent duplicate payments).
   (5) Establish a cash on hand fund. For control assign it to one person who is not involved in recordkeeping.
   (6) Exercise strict control of write-offs of uncollectible accounts, including approval by the owner.
   (7) Continue the annual audit.