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SUBJECT: **<u>INTRODUCTION OF FINANCIAL ACCOUNTING</u>**
SUBMITTED TO: **<u>NAVEED AZEEM KHATTAK</u>**

MID TERM (SUMMERS)

Attempt all questions. Each question carries equals marks.

Q1) Doubtful account (bad debt) is one of the most important concepts in accounting. Explain the concept of doubtful account and how one can adjust it. Interpret its both adjustment methods with example.

ANS) <u>Doubtful account:</u>

A provision for doubtful accounts, or bad debt reserve, is an offset account (has a credit balance or a zero balance) that reduces accounts receivable. By creating a dubious account registration allowance, it is estimated that some customers will not pay you the money they owe.

When customers don't pay you, your expense account with bad debts increases. Bad debt is the debt that you have officially written off as uncollectable. Its money you thought you'd get, but it's not, so it has an impact on your company's performance.

Unlike bad debt, doubtful debt is not officially uncollectible. Instead, dubious debt money you foresee will turn into bad debt, but there is still a chance that you will get the money.

If you give credit to customers, use the accrual method. When customers buy from you but don't pay right away, you need to increase your credits. This is the money you owe to your business. But sometimes customers never pay you.

Unpaid payments become unpaid debts. Suddenly, having a lot of bad credits reduces the amount of revenue your company should have. ADA accounting helps increase the accuracy of your books. By predicting the number of accounts that customers will not pay, you can anticipate losses associated with bad loans.

How one can adjust it:-

To account for doubtful account, create an allocation, which is posted to your balance sheet. The balance sheet shows the company's assets, liabilities and capital. An allowance for doubtful accounts reduces the reported amount of Accounts Receivable.

An allowance for bad accounts is determined in a reserve account (also known as a counter account) that reduces your accounts receivable, so it is posted to assets, such as a reduction after the credit transaction line. Calculate the number of claims that can be converted into bad debts for a certain period of time and enter a credit of this amount into your reserve account- this is the allowance of your doubtful account.

In other words, in your double income books, take your account for bad debts and credit your cash compensation. When there is an inseparable debt, charge your cashiers and credit your credit account.

For Example:

The X-PRO company has $300,000 in claims, of which it estimates that $20,000 will eventually become bad debt. As a result, they charge $20,000 at the expense of bad debt (as shown in the income account) and a credit for compensation for bad accounts (which appears just below the line of trade receivables in the balance sheet). A month later, X-PRO knows that a $2,000 bill is really a bad debt. It creates a credit memo for $2,000, reducing account claims by $2,000 and bonus for questionable accounts by $2,000.

Thus, when X-PRO recognizes the actual bad debt, there is no impact on the income statement - only a reduction in commercial receivables and the provision of unsecured item accounts in the balance sheet, and those that are covered against each other.

The two most common methods you can use to write off bad debt are the direct write-off method and the allowance method.

Two methods:

Direct Write-Off method

Allowance Method

Direct Write-Off method:

The direct depreciation method is used only when we decide that a customer does not have to pay. We do not record estimates or use allowance for doubtful accounts using the direct write off method. We post bad debt expenses for the amount we determine will not be paid. This method violates the matching principle for income and expenses recognized during the same period.

Allowance Method:

The allowance method follows the GAAP matching policy because we estimate the non-receivable accounts by the end of the year. We use this estimate to record bad debt expenses and create a backup account called "allowance for doubtful account" (also known as "Non-Collection Account Deductions") based on past experience with previous accounts waiting. We can calculate these estimates on the basis of sales (profit approach) for the year or in the balance sheet of receivables at the time of the estimate (balance sheet approach).

In general, companies will choose between two approaches according to the allowance method.

Percentage of sales

Using historical data, a company examines the relationship between sales accounts and debt accounts.

For example,

A company may find a historical trend showing that 2% of credit sales are never collected by customers. If this company had 100,000 credit sales in the current period, it will also post the following journal entry:

Date	Account	Debit	Credit
3/31/20XX	Bad Debts Expense		5,000
Allowance for Doubtful Accounts			4, 00

Q2) The ledger of Nuro Company at the end of the current year shows Accounts Receivable $180,000, Sales Revenue $1,800,000, and Sales Returns and Allowances $60,000.

Instructions

(a) If Nuro uses the direct write-off method to account for uncollectible accounts, journalize the adjusting entry at December 31, assuming Nuro determines that Willie's $2,900 balance is uncollectible.

(b) If Allowance for Doubtful Accounts has a credit balance of $4,300 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be (1) 1 % of net sales, and (2) 10% of accounts receivable.

(c) If Allowance for Doubtful Accounts has a debit balance of $410 in the trial balance, journalize the adjusting entry at December 31, assuming bad debts are expected to be (1) 0.75% of net sales and (2) 6% of accounts receivable.

ANS)

Solution:

Adjusting entries

December 31

	Date	Accounts	Debit	Credit
(A)	Dec31	Bad Debt expense	2900	
		Account receivables-Willies		2900
(B)	(1) Dec31	Bad debt Expense		
		[($1,800,000-60,000) * 1%]	17,400	
		Allowances for Doubtful Accounts		17,400
	(2) Dec 31	Bad Debt Expense	13,700	
		Allowance for Doubtful		
		Accounts [($1,800,000 * 10%) - $4,300]		13,700
(C)	(1) Dec 31	Bad Debt Expense		
		[($1,800,000 - $60,000) * 0.75%]	13,050	
		Allowances for doubtful Accounts		13,050
	(2)	Bad Debt Expense	11,210	
		Allowance for Doubtful		
		Accounts [(180,000*6%) + $410]		11,210

Q3) Accounting equation is the basic accounting model that is adopted while performing any record. Interpret the basic components of accounting equation model in detail.

ANS) <u>Basic components of accounting equation:</u>

The accounting equation is a basic principle of accounting and a essential element of the balance sheet. The equation is as follows:

Assets = Liabilities + Shareholder's Equity

This equation lays the groundwork for dual-entry accounting and highlights the balance sheet structure. Dual entry accounting is a system in which each transaction affects both sides of the accounting equation. For any change to an asset account, a change of relevant liability or capital account must be made. It is important to consider the accounting equation when performing entries.

The accounting equation helps assess whether business transactions conducted by the company are accurately reflected in your books and accounts. Here are some examples of items listed in the balance sheet:

Assets:

Assets are valuable things that belong to a company.

There are several categories of business assets, including long-term assets, capital assets, investments and tangible assets. They were purchased by borrowing money from creditors, receiving cash from owners and shareholders or offering goods or services.

Enterprise current assets include cash and commercial receivables, while long-term assets include promissory claims. Items such as facilities, real estate and equipment are considered capital assets. Securities belonging to a company, such as shares and bonds, are called investments. Intangible assets included in the company's balance sheet include trademarks, goodwill, patents and copyrights.

LIABILITIES:

Obligations to other companies and individuals are considered liabilities and can be classified as current and long-term liabilities.

Because of the year, current debts in a balance sheet include accounts payable, salaries or salaries to be paid, and taxes to pay. Long-term liabilities are usually due to lenders and include notes to be paid and, if appropriate, unearned income.

Income not earned from money you have not yet received for services or products you have not yet delivered is considered an obligation.

SHAREHOLDERS' EQUITY:

The income that a shareholder of the company can claim after the payment of the debts was shareholder equity.

Shareholder equity is equal to the total assets of a company minus its total liabilities. It can be found on a balance sheet and is one of the most important metrics for analysts to assess the financial health of a company.

Equity represents the net or carrying amount of an asset.

Retained profits are part of the share capital and are equal to the percentage of unpaid net profits to shareholders in the form of dividends. Think of re-earnings as savings, as it represents a cumulative set of profits that have been saved and set aside or withheld for future use.

The Double-Entry System:

The accounting equation forms the basis of the dual-entry accounting and is a summary representation of a concept that extends to the complex, expanded and multi-component representation of a balance sheet. The balance sheet is based on the dual-record accounting system in which a company's total assets are equal to the total liabilities and equity of shareholders. In fact, representation equates all uses of capital (assets) to all sources of capital, where debt leads to liabilities and shares leads to equity.

Cash Flow vs. Balance Sheet:

The cash flow statement shows the amount of cash that a company issues. The Cash Flow Statement (CFS) measures how a company manages and generates liquidity to repay its liabilities and finance operating expenses.

The balance sheet is a summary of an entity's financial balances and a cash flow statement shows how changes in balance sheet accounts and profit and loss account results affect a company's cash position.