FA Module 4: The balance sheet (statement of financial position) – explanations

Fair value

Question: How is fair value defined?

Answer: The textbook defines fair value for IFRS and for GAAP as follows:

- Under IFRS, fair value is the amount at which an asset could be exchanged or a liability settled in an arm's length transaction between knowledgeable and willing parties.
- Under US GAAP, the definition is similar but it is based on an exit price, the price received to sell an asset or paid to transfer a liability, rather than an entry price.

The distinction in the textbook is strange. The IFRS fair value is the exit price, not the entry price. The entry price is the price paid for the asset. The IFRS definition, "the amount at which an asset could be exchanged or a liability settled in an arm's length transaction between knowledgeable and willing parties," is the exit price.

Cash equivalents and marketable securities

Question: Are cash equivalents the same as marketable securities?

Answer: Cash equivalents and marketable securities differ by their maturities.

- Cash equivalents have original maturities of three months or less.
- Marketable securities are fixed income securities with maturities of less than one year.

See page 200 of the textbook.

Bad debt

Question: What are bad debt expenses, allowances for doubtful accounts, and write-offs?

Answer: Distinguish balance sheet vs income statement item and actual vs expected amounts:

Allowances for doubtful accounts are contra-assets on the balance sheet, reflecting the expected amount of accounts receivable that will not be collected. They are estimates for groups of accounts, such as 5% of all accounts, or 15% of accounts that are 90 days past due.

Bad debt expenses are income statement charges for the change in the allowance for doubtful accounts.

If the firm estimates that specific receivables will not be collected, these accounts receivable are written off and removed from the balance sheet. The allowance for doubtful accounts is reduced to reflect the lower receivables. The write off is a charge to income and the reduction of the allowance for doubtful accounts is a credit to income.

Illustration: A firm begins operations on January 1, 20X1, and it sells goods on credit in 20X1. At December 31, 20X1, it has 100 of accounts receivable, of which 70 are not yet due, 20 are between 0 and 90 days due, and 10 are more than 90 days past due. The firm estimates that 1% of receivables not yet due will not be collected, 5% of receivables between 0 and 90 days due will not be collected, and 20% of receivables more than 90 days past due will not be collected. Its allowance for doubtful accounts is

$1\% \times 70 + 5\% \times 20 + 20\% \times 10 = 3.70$.

The increase in the allowance for doubtful accounts is $3.70 - 0 = 3.70$, which is a charge to income (the bad debt expense).

If the firm believed that 1 account more than 90 days past due with a receivable of 4 is uncollectible, it would write off that account by a credit of 4 to accounts receivable and an offsetting debit of 4 to net revenue. It would also reduce the allowance for doubtful account by $20\% \times 4 = 0.8$ and the bad debt expense by 0.8.

See pages 202 of the textbook: “To record the estimated bad debts, a company recognizes a bad debt expense (which affects net income) and increases the balance in the allowance for doubtful accounts by the same amount. To record the write-off of a particular account receivable, a company reduces the balance in the allowance for doubtful accounts and reduces the balance in accounts receivable by the same amount.”