cHAPTER 7

accounting for receivables

|  |
| --- |
| Chapter Outline |
| **I. Valuing Accounts Receivable—**Amounts due from customers for credit sales. They occur when a customer uses credit cards and when a company gives credit directly to customers. |
| A. Sales on Credit |
| 1. Increase (debit) Accounts Receivable for the full amount of the sale and increase (credit) Sales. 2. The General Ledger continues to keep a single (total) Accounts Receivable Account. (control account) 3. A supplementary record, called the Accounts Receivable (subsidiary) Ledger, maintains a separate account receivable for each customer. 4. A *Schedule of Accounts Receivable* shows that the sum of the individual accounts in the subsidiary ledger equals the balance of the Accounts Receivable account in the general ledger.   B. Sales on Bank Credit Cards  1. Credit card sales (Examples: Visa, Mastercard, or American Express). |
| a.Advantages: (1) eliminates the company’s need to evaluate each customer’s credit standing (2) avoids seller’s risk (3) seller receives cash sooner than when they grant credit directly (4) more credit options potentially increase sales. |
| b. Bank credit card sales: Cash received immediately on deposit - results in debit to Cash for the amount of sale less the credit card company charge, debit to Credit Card Expense for this fee and credit to Sales for full invoice amount.  c. Store credit card sales: Cash received some time after deposit of sales receipt - results in debit to Accounts Receivable for the amount to be collected, and a debit to Credit Card expense for the amount of the fee and credit to Sales for full invoice. Later, when payment is received, debit Cash and credit Accounts Receivable. |
| **II. Direct Write-Off Method**—accounts of customers who do not pay are uncollectible accounts, commonly called *bad debts*. Two methods are used to account for uncollectible accounts:  1. direct write-off method  2. allowance method |
| A**.** Recording and Writing Off Bad Debts: record loss when it is determined to be uncollectible. Debit Bad Debt Expense; credit Accounts Receivable.  B.Recovering a Bad Debt: if a written off account is later collected, results in a reversal of the write-off (see above) and a normal collection of account entry. |
| C.UsingDirect Write-Off Method—must weigh concepts of expense recognition and materiality:  1.Expense recognition —requires expenses be reported in the same period as the sales they helped produce.  2. Materiality constraint—GAAP permits use of the simple, low-cost direct write-off method when its results approximate those using the allowance method. |
| **III. Allowance Method**—matches the *estimated* loss from uncollectibles against the sales they helped produce.   1. Use estimated losses because when a sale occurs, we do not know which customers will not pay. 2. At the end of the period, the allowance method requires an estimate of the total bad debts expected from that period’s sales. 3. Two advantages of method: 4. Records estimated bad debts expense in the period when the related sales are recorded. 5. Reports accounts receivable on the balance sheet at the estimated amount to be collected. 6. Recording Bad Debts Expense: at end of each accounting period, bad debts expense is *estimated* and recorded with an adjusting entry. |
| 1. To record estimate of bad debt expense, Debit Bad Debt Expense, credit a contra-asset account called Allowance for Doubtful Accounts. 2. The Allowance for Doubtful Accounts is a contra asset account. 3. Realizable value is the amount expected to be received. 4. Writing off Bad Debt: 5. When specific accounts become uncollectible, they are written off against the Allowance for Doubtful Accounts. 6. Debit Allowance for Doubtful Accounts, credit Accounts Receivable.   3. Writing off an uncollectible does not change the estimated amount of cash to be collected  D. Recovering a Bad Debt—if an amount that was written off is later collected, two entries are made.  1. The first entry reverses the write-off and reinstates the customer’s account.  2. The second entry records the collection of the reinstated account. |
|  |
| **IV.** **Estimating Bad Debts—two methods:** |
| 1. Percent of sales method or income statement method—assumes that a percent of credit sales for the period is uncollectible. Bad debts expense is computed as a percentage of sales for the period. (% x sales = Bad Debt Expense) |
| 1. Sales figure chosen as base is usually *credit* sales but it can be total or net sales if cash sales are small.  2. The estimate is used in the adjusting entry. Note that the resulting reported allowance account balance is rarely equal the reported expense because the allowance account was not likely to be zero prior to adjustment. |
| B. Percent of accounts receivables method, a balance sheet method—assumes that a percent of a company’s receivables is uncollectible. Desired credit balance in Allowance for Doubtful Accounts is computed: (% x AR = Desired balance in Allowance for Doubtful Accounts). Estimated balance for allowance account obtained as: |
| 1. As a percentage of outstanding receivables or 2. Aging accounts receivable—another balance sheet method, applied like the percent of receivables method except that several percentages are used, instead of one, to estimate the allowance.   The amount in the adjustment (Bad Debts Expense) is calculated by determining the amount necessary to bring allowance account to a credit balance equivalent to the estimated uncollectibles. |
| **V. Notes Receivable—***Promissory note* that is a written promise to pay a specified amount *(principal)* usually with interest, either on demand or on a stated future date. Promissory notes are notes payable to the *maker* (person promising to pay) and notes receivable to the *payee* (person to be paid)*. Interest* is the charge for using money until the due date. |
| 1. Computing Maturity and Interest   1. *Maturity date* is the date the note must be repaid.  2. Amount to be repaid is principal plus interest (*maturity value*).  3. The *period* of the note is the time from the note’s date to its maturity date.  4. Formula for computing annual interest:  Principal **x** Annual interest rate **x** time (fraction of year) **=** Interest |
| 1. Recording Notes Receivable—debit Notes Receivable for principal or face amount of note. Credit will vary; depends on reason note is received. Interest is not recorded until earned. |
| C. Valuing and Settling Notes  1. Recording an Honored Note—debit Cash for maturity value (face value and interest), credit Note Receivable for face value and credit Interest Revenue for the interest amount. |
| 2. Recording a Dishonored Note—debit Accounts Receivable for maturity value (face value + Interest), credit Note Receivable for face amount and credit Interest Revenue for the interest amount. If account receivable remains uncollected, it will be written-off.  3.Recording End-of-Period Interest Adjustment—record accrued interest by debiting Interest Receivable and crediting Interest Revenue for accrued interest earned.  4.Collection entry if some interest was accrued requires a debit to Cash for full amount received, credits to Interest Receivable (amount previously accrued), Interest Revenue (amount earned since accrual date) and Notes Receivable (face amount of note). |
| D. Disposal of Receivables—Companies can convert receivables to cash before they are due. Reasons for this include the need for cash or do not want to be involved in collection activities. |
| 1. Selling Receivables 2. Buyer, called a *factor*, charges the seller a *factoring fee* and then collects the receivables as they come due. 3. Entry: debit Cash (amount received), and Factoring Fee Expense (amount charged) and credit Accounts Receivable (amount sold). |
| E. Pledging Receivables  1. Company borrows money by pledging its receivables as security.  2.Borrower retains ownership of the receivables.  3. If borrower defaults, the lender has right to be paid from receipts on accounts receivable when collected.  4. The pledge should be disclosed in financial statement footnotes.  5.The loan is recorded as a debit to Cash and a credit to Notes Payable. |
| **VI. Decision Analysis—Accounts Receivable Turnover** |
| 1. Measures both the quality (likeliness of collecting) and liquidity (speed of collection) of accounts receivable, 2. Measures how often, on average, receivables are received and collected during the period. 3. Calculated by dividing net sales by average accounts receivable. |