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MIDOCEAN  
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# Principles of Accounting

## Lecture 5

MGM 227

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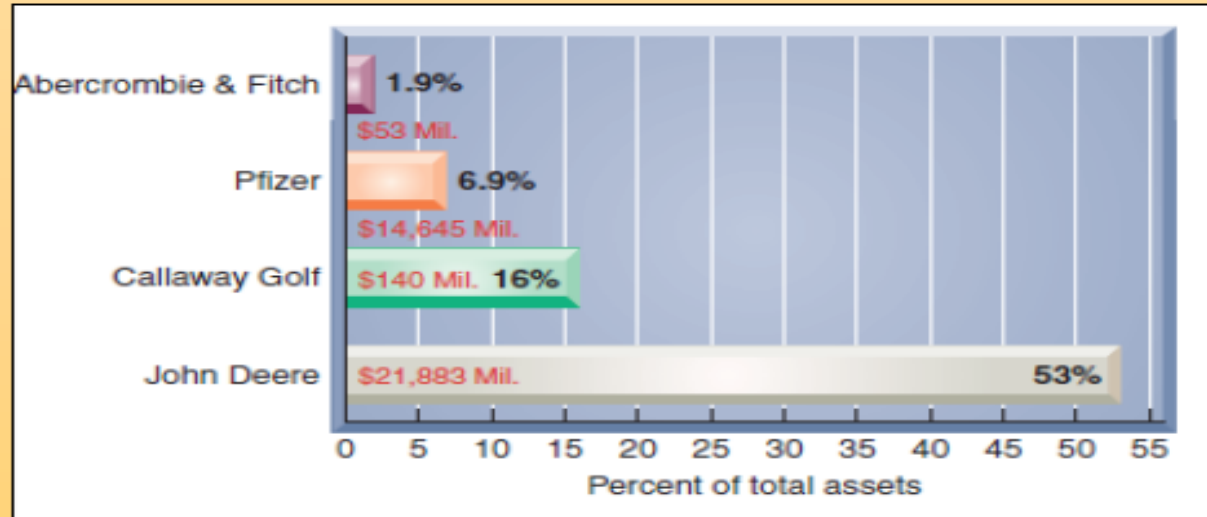
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# ACCOUNTING FOR RECEIVABLES



# Accounts Receivable

A receivable is an amount due from another party.



This graph shows recent dollar amounts of receivables and their percent of total assets for four well-known companies.

A company must also maintain a separate account for each customer that tracks how much that customer purchases, has already paid, and still owes.

C1

# Sales on Credit

On July 1, TechCom had a credit sale of \$950 to CompStore and a collection of \$720 from RDA Electronics from a prior credit sale.

|        |                                              |     |     |
|--------|----------------------------------------------|-----|-----|
| July 1 | Accounts Receivable—CompStore .....          | 950 |     |
|        | Sales .....                                  |     | 950 |
|        | <i>To record credit sales*</i>               |     |     |
| July 1 | Cash .....                                   | 720 |     |
|        | Accounts Receivable—RDA Electronics .....    |     | 720 |
|        | <i>To record collection of credit sales.</i> |     |     |

# Sales on Credit

|        |                                              |     |     |
|--------|----------------------------------------------|-----|-----|
| July 1 | Accounts Receivable—CompStore .....          | 950 |     |
|        | Sales .....                                  |     | 950 |
|        | <i>To record credit sales*</i>               |     |     |
| July 1 | Cash .....                                   | 720 |     |
|        | Accounts Receivable—RDA Electronics .....    |     | 720 |
|        | <i>To record collection of credit sales.</i> |     |     |

| General Ledger      |    |       |        |         |
|---------------------|----|-------|--------|---------|
| Accounts Receivable |    |       |        |         |
| Date                | PR | Debit | Credit | Balance |
| June 30             |    | 3,000 |        | 3,000   |
| July 1              |    | 950   |        | 3,950   |
| July 1              |    |       | 720    | 3,230   |

| Accounts Receivable Ledger |    |       |        |         |
|----------------------------|----|-------|--------|---------|
| RDA Electronics            |    |       |        |         |
| Date                       | PR | Debit | Credit | Balance |
| June 30                    |    | 1,000 |        | 1,000   |
| July 1                     |    |       | 720    | 280     |
| CompStore                  |    |       |        |         |
| Date                       | PR | Debit | Credit | Balance |
| June 30                    |    | 2,000 |        | 2,000   |
| July 1                     |    | 950   |        | 2,950   |

| TechCom                         |                |
|---------------------------------|----------------|
| Schedule of Accounts Receivable |                |
| RDA Electronics.....            | \$ 280         |
| CompStore.....                  | 2,950          |
| Total.....                      | <u>\$3,230</u> |

# Credit Card Sales

## Advantages of allowing customers to use credit cards:

Customers' credit is evaluated by the credit card issuer.

Sales increase by providing purchase options to the customer.

The risks of extending credit are transferred to the credit card issuer.

Cash collections are quicker.



# Credit Card Sales

On July 15<sup>th</sup>, TechCom has \$100 of credit card sales with a 4% fee, and its \$96 cash is received immediately on deposit.

|         |                                                                    |    |     |
|---------|--------------------------------------------------------------------|----|-----|
| July 15 | Cash .....                                                         | 96 |     |
|         | Credit Card Expense .....                                          | 4  |     |
|         | Sales .....                                                        |    | 100 |
|         | <i>To record credit card sales less a 4% credit card expense.*</i> |    |     |



# Credit Card Sales

If instead TechCom must remit electronically the credit card sales receipts to the credit card company and wait for the \$96 cash payment, we will make the first entry on July 15, and the second entry on July 20, when the cash is received.

|         |                                                                  |    |     |
|---------|------------------------------------------------------------------|----|-----|
| July 15 | <b>Accounts Receivable—Credit Card Co.</b> .....                 | 96 |     |
|         | Credit Card Expense .....                                        | 4  |     |
|         | Sales .....                                                      |    | 100 |
|         | <i>To record credit card sales less 4% credit card expense.*</i> |    |     |
| July 20 | Cash .....                                                       | 96 |     |
|         | Accounts Receivable—Credit Card Co. ....                         |    | 96  |
|         | <i>To record cash receipt.</i>                                   |    |     |

# Installment Accounts Receivable

Amounts owed by customers from credit sales for which payment is required in periodic amounts over an extended time period. The customer is usually charged interest.



Ford Motor Company reports more than \$75 billion in installment receivables.

# Valuing Accounts Receivable

Some customers may not pay their account.  
Uncollectible amounts are referred to as bad debts.

There are two methods of  
accounting for bad debts:

- Direct Write-Off Method
- Allowance Method



# Direct Write-Off Method

TechCom determines on January 23 that it cannot collect \$520 owed to it by its customer J. Kent.

|         |                                               |     |     |
|---------|-----------------------------------------------|-----|-----|
| Jan. 23 | Bad Debts Expense .....                       | 520 |     |
|         | Accounts Receivable—J. Kent .....             |     | 520 |
|         | <i>To write off an uncollectible account.</i> |     |     |

Notice that the specific customer is noted in the transaction so we can make the proper entry in the customer's Accounts Receivable subsidiary ledger.

# Direct Write-Off Method – Recovering a Bad Debt

On March 11, J. Kent was able to make full payment to TechCom for the amount previously written-off.

|         |                                                     |     |     |
|---------|-----------------------------------------------------|-----|-----|
| Mar. 11 | Accounts Receivable—J. Kent .....                   | 520 |     |
|         | Bad Debts Expense .....                             |     | 520 |
|         | <i>To reinstate account previously written off.</i> |     |     |
| Mar. 11 | Cash .....                                          | 520 |     |
|         | Accounts Receivable—J. Kent .....                   |     | 520 |
|         | <i>To record full payment of account.</i>           |     |     |

# Matching vs. Materiality

The matching (expense recognition) principle requires expenses to be reported in the same accounting period as the sales they helped produce.



Materiality states that an amount can be ignored if its effect on the financial statements is unimportant to users' business decisions.

The direct write-off method usually does not best match sales and expenses.

# P1 Allowance Method

At the end of each period, **estimate** total bad debts expected to be realized from that period's sales.



Two advantages to the allowance method:

1. It records estimated bad debts expense in the period when the related sales are recorded.
2. It reports accounts receivable on the balance sheet at the estimated amount of cash to be collected.

# Recording Bad Debts Expense

TechCom had credit sales of \$300,000 during its first year of operations. At the end of the first year, \$20,000 of credit sales remained uncollected. Based on the experience of similar businesses, TechCom estimated that \$1,500 of its accounts receivable would be uncollectible.

|         |                                       |       |       |
|---------|---------------------------------------|-------|-------|
| Dec. 31 | Bad Debts Expense .....               | 1,500 |       |
|         | Allowance for Doubtful Accounts ..... |       | 1,500 |
|         | <i>To record estimated bad debts.</i> |       |       |

| Accounts Receivable |        |  | Allowance for Doubtful Accounts |         |       |
|---------------------|--------|--|---------------------------------|---------|-------|
| Dec. 31             | 20,000 |  |                                 | Dec. 31 | 1,500 |

# Balance Sheet Presentation

TechCom had credit sales of \$300,000 during its first year of operations. At the end of the first year, \$20,000 of credit sales remained uncollected. Based on the experience of similar businesses, TechCom estimated that \$1,500 of its accounts receivable would be uncollectible.

## Current assets

|                                            |              |          |
|--------------------------------------------|--------------|----------|
| Accounts receivable .....                  | \$20,000     |          |
| Less allowance for doubtful accounts ..... | <u>1,500</u> | \$18,500 |

# Writing Off a Bad Debt

TechCom decides that J. Kent's \$520 account is uncollectible.

|         |                                               |     |     |
|---------|-----------------------------------------------|-----|-----|
| Jan. 23 | Allowance for Doubtful Accounts .....         | 520 |     |
|         | Accounts Receivable—J. Kent .....             |     | 520 |
|         | <i>To write off an uncollectible account.</i> |     |     |

| Accounts Receivable |         |     | Allowance for Doubtful Accounts |         |       |
|---------------------|---------|-----|---------------------------------|---------|-------|
| Dec. 31             | 20,000  |     |                                 | Dec. 31 | 1,500 |
|                     | Jan. 23 | 520 | Jan. 23                         | 520     |       |

# Writing Off a Bad Debt

The write-off does not affect the realizable value of accounts receivable.

|                                                | Before Write-Off       | After Write-Off        |
|------------------------------------------------|------------------------|------------------------|
| Accounts receivable .....                      | \$ 20,000              | \$ 19,480              |
| Less allowance for doubtful accounts .....     | <u>1,500</u>           | <u>980</u>             |
| Estimated realizable accounts receivable ..... | <u><u>\$18,500</u></u> | <u><u>\$18,500</u></u> |

# Recovering a Bad Debt

To help restore credit standing, a customer sometimes volunteers to pay all or part of the amount owed on an account even after it has been written off.

On March 11, Kent pays in full his \$520 account previously written off.

|         |                                                     |     |     |
|---------|-----------------------------------------------------|-----|-----|
| Mar. 11 | Accounts Receivable—J. Kent .....                   | 520 |     |
|         | Allowance for Doubtful Accounts .....               |     | 520 |
|         | <i>To reinstate account previously written off.</i> |     |     |
| Mar. 11 | Cash .....                                          | 520 |     |
|         | Accounts Receivable—J. Kent .....                   |     | 520 |
|         | <i>To record full payment of account.</i>           |     |     |

# Estimating Bad Debts Expense

## Two Methods

1. Percent of Sales Method
2. Accounts Receivable Methods
  - Percent of Accounts Receivable
  - Aging of Accounts Receivable



# Percent of Sales Method

Bad debts expense is computed as follows:

|          |                                    |
|----------|------------------------------------|
|          | <b>Current Period Sales</b>        |
| <b>×</b> | <b>Bad Debt %</b>                  |
| <b>=</b> | <b>Estimated Bad Debts Expense</b> |

# Percent of Sales Method

Musicland has credit sales of \$400,000 in 2011. It is estimated that 0.6% of credit sales will eventually prove uncollectible.

Let's look at recording Bad Debts Expense for 2011.

$$\begin{array}{r}
 \$ \quad 400,000 \\
 \times \quad \quad 0.6\% \\
 \hline
 = \quad \$ \quad 2,400
 \end{array}$$

**Musicland's accountant  
computes estimated  
Bad Debts Expense of  
\$2,400.**

|         |                                       |       |       |
|---------|---------------------------------------|-------|-------|
| Dec. 31 | Bad Debts Expense .....               | 2,400 |       |
|         | Allowance for Doubtful Accounts ..... |       | 2,400 |
|         | <i>To record estimated bad debts.</i> |       |       |

# Percent of Receivables Method

- 1. Compute the estimate of the Allowance for Doubtful Accounts.**

$$\text{Year-end Accounts Receivable} \times \text{Bad Debt \%}$$

- 2. Bad Debts Expense is computed as:**

|                                         |
|-----------------------------------------|
| Total Estimated Bad Debts Expense       |
| – Previous Balance in Allowance Account |
| = Current Bad Debts Expense             |
|                                         |

# Percent of Receivables Metho

Musicland has \$50,000 in accounts receivable and a \$200 credit balance in Allowance for Doubtful Accounts on December 31, 2011. Past experience suggests that 5% of receivables are uncollectible.

Desired balance in Allowance for Doubtful Accounts.

$$\begin{array}{r}
 \$ \quad 50,000 \\
 \times \quad 5.00\% \\
 \hline
 = \$ \quad 2,500
 \end{array}$$

| Allowance for Doubtful Accounts |     |                                 |
|---------------------------------|-----|---------------------------------|
| Feb. 6                          | 800 |                                 |
| July 10                         | 700 |                                 |
| Nov. 20                         | 500 |                                 |
|                                 |     | Dec. 31, 2010, bal. 2,200       |
|                                 |     | Unadjusted bal. 200             |
|                                 |     | <b>Dec. 31 adjustment 2,300</b> |
|                                 |     | Dec. 31, 2011, bal. 2,500       |

|         |                                       |       |       |
|---------|---------------------------------------|-------|-------|
| Dec. 31 | Bad Debts Expense .....               | 2,300 |       |
|         | Allowance for Doubtful Accounts ..... |       | 2,300 |
|         | <i>To record estimated bad debts.</i> |       |       |

# Aging of Receivables Method

**Classify each receivable by how long it is past due.**

**Each age group is multiplied by its estimated bad debts percentage.**

**Estimated bad debts for each group are totaled.**



# Aging of Accounts Receivable

## MUSICLAND Schedule of Accounts Receivable by Age December 31, 2011

| Customer                   | Totals                 | Not Yet Due   | 1 to 30 Days Past Due | 31 to 60 Days Past Due | 61 to 90 Days Past Due | Over 90 Days Past Due |
|----------------------------|------------------------|---------------|-----------------------|------------------------|------------------------|-----------------------|
| Carlie Abbott.....         | \$ 450                 | \$ 450        |                       |                        |                        |                       |
| Jamie Allen.....           | 710                    |               |                       | \$ 710                 |                        |                       |
| Chavez Andres.....         | 500                    | 300           | \$ 200                |                        |                        |                       |
| Balicia Company.....       | 740                    |               |                       |                        | \$ 100                 | \$ 640                |
| <hr/>                      |                        |               |                       |                        |                        |                       |
| Zamora Services.....       | <u>1,000</u>           | <u>810</u>    | <u>190</u>            |                        |                        |                       |
| Total receivables.....     | \$50,000               | \$37,000      | \$6,500               | \$3,700                | \$1,900                | \$ 900                |
| Percent uncollectible..... |                        | × 2%          | × 5%                  | × 10%                  | × 25%                  | × 40%                 |
| Estimated uncollectible..  | <u><b>\$ 2,270</b></u> | <u>\$ 740</u> | <u>\$ 325</u>         | <u>\$ 370</u>          | <u>\$ 475</u>          | <u>\$ 360</u>         |

# Aging of Accounts Receivable

Musicland has an unadjusted credit balance in the allowance account is \$200.

We estimated the proper balance to be \$2,270.

## Allowance for Doubtful Accounts

|  |       |
|--|-------|
|  | 200   |
|  | 2,070 |
|  | 2,270 |

Dec. 31

Bad Debts Expense .....

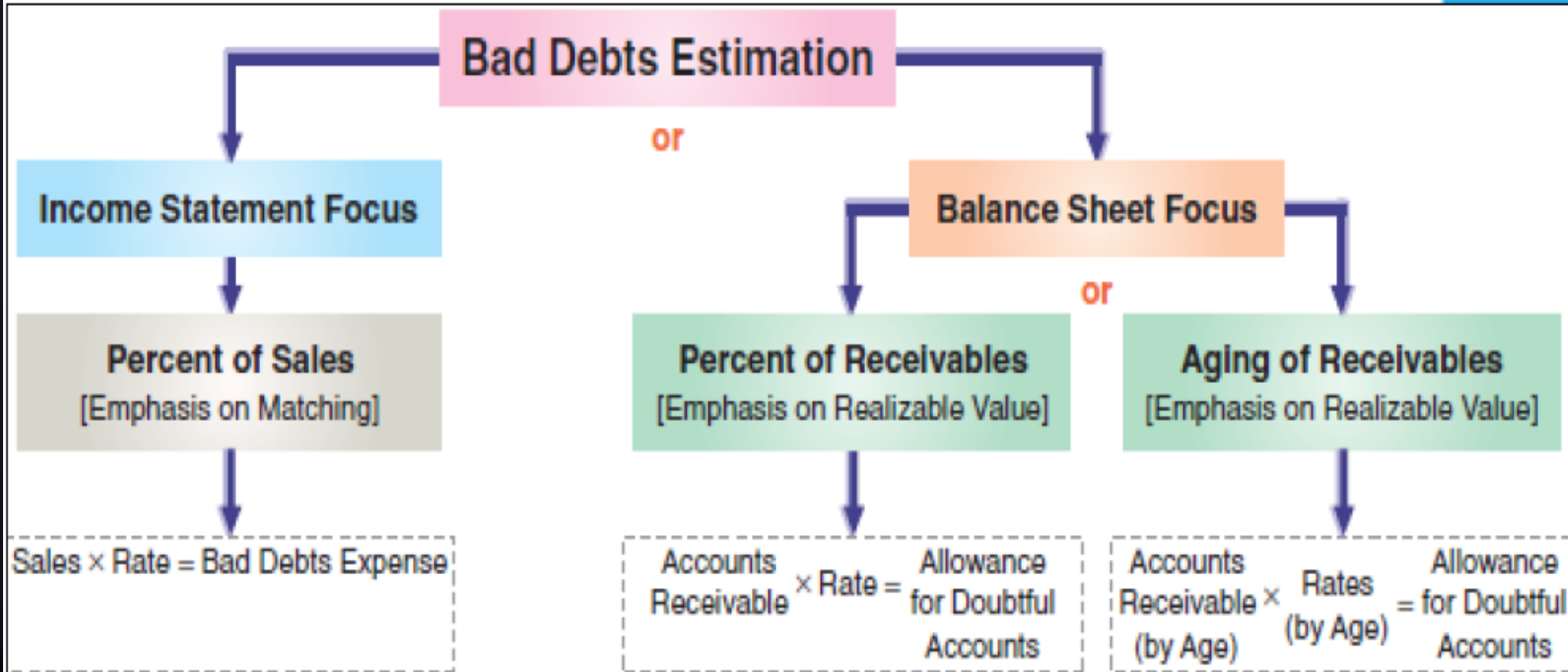
2,070

Allowance for Doubtful Accounts .....

2,070

*To record estimated bad debts.*

# Summary of Methods



# Notes Receivable

A promissory note is a written promise to pay a specified amount of money, usually with interest, either on demand or at a definite future date.

**Promissory Note**

**Amount:** \$1,000 **Date:** July 10, 2011

Ninety days after date ..... I ..... promise to pay to the order of

**TechCom Company**  
Los Angeles, CA

One thousand and no/100 ..... Dollars

for value received with interest at the annual rate of ...12%...

payable at ... First National Bank of Los Angeles, CA

*Julia Browne*

**Principal**

**Date of note**

**Due date**

**Payee**

**Interest rate**

**Maker**

# Computing Maturity and Interest

The maturity date of a note is the day the note (principal and interest) must be repaid.

On July 10, 2011, TechCom received a \$1,000, 90-day, 12% promissory note as a result of a sale to Julia Browne.

|                                                                   |                  |   |            |
|-------------------------------------------------------------------|------------------|---|------------|
| Days in July .....                                                | 31               |   |            |
| Minus the date of the note .....                                  | <u>10</u>        |   |            |
| Days remaining in July .....                                      | 21               | ← | July 11–31 |
| Add days in August .....                                          | 31               | ← | Aug. 1–31  |
| Add days in September .....                                       | 30               | ← | Sept. 1–30 |
| Days to equal 90 days, or <b>maturity date of October 8</b> ..... | <u>8</u>         | ← | Oct. 1–8   |
| Period of the note in days .....                                  | <u><u>90</u></u> |   |            |

**The note is due and payable on October 8, 2011.**

# Interest Computation

$$\text{Principal of the note} \times \text{Annual interest rate} \times \text{Time expressed in fraction of year} = \text{Interest}$$

Even for maturities less than one year, the rate is annualized.

If the note is expressed in days, base a year on 360 days.

$$\$1,000 \times 12\% \times \frac{90}{360} = \$1,000 \times 0.12 \times 0.25 = \$30$$

# Recognizing Notes Receivable

Notes receivable are usually recorded in a single Notes Receivable account to simplify recordkeeping. The original notes are kept on file, including information on the maker, rate of interest, and due date.

To illustrate the recording for the receipt of a note, we use the \$1,000, 90-day, 12% promissory note from Julia Browne to TechCom. TechCom received this note at the time of a product sale to Julia Browne.

|          |                                                       |       |       |
|----------|-------------------------------------------------------|-------|-------|
| July 10* | Notes Receivable .....                                | 1,000 |       |
|          | Sales .....                                           |       | 1,000 |
|          | <i>Sold goods in exchange for a 90-day, 12% note.</i> |       |       |

\* We omit the entry to Dr. Cost of Sales and Cr. Merchandise Inventory to focus on sales and receivables.

# Recording an Honored Note

The principal and interest of a note are due on its maturity date.



J. Cook has a \$600, 15%, 60-day note receivable due to TechCom on December 4.

|        |                                                                                     |     |     |
|--------|-------------------------------------------------------------------------------------|-----|-----|
| Dec. 4 | Cash .....                                                                          | 615 |     |
|        | Notes Receivable .....                                                              |     | 600 |
|        | Interest Revenue .....                                                              |     | 15  |
|        | <i>Collect note with interest of <math>\\$600 \times 15\% \times 60/360</math>.</i> |     |     |

# Recording a Dishonored Note

The act of dishonoring a note does not relieve the maker of the obligation to repay the principal and interest due.

TechCom holds an \$800, 12%, 60-day note of Greg Hart. At maturity, October 14, Hart dishonors the note.

|         |                                                                                                                              |     |     |
|---------|------------------------------------------------------------------------------------------------------------------------------|-----|-----|
| Oct. 14 | Accounts Receivable—G. Hart .....                                                                                            | 816 |     |
|         | Interest Revenue .....                                                                                                       |     | 16  |
|         | Notes Receivable .....                                                                                                       |     | 800 |
|         | <i>To charge account of G. Hart for a dishonored note<br/>and interest of <math>\\$800 \times 12\% \times 60/360</math>.</i> |     |     |

# Recording End-of-Period Interest Adjustments

**On December 16, TechCom accepts a \$3,000, 60-day, 12% note from a customer in granting an extension on a past-due account. When TechCom's accounting period ends on December 31, \$15 of interest has accrued on the note.**

$$\$3,000 \times 12\% \times 15/360 = \$15$$

|         |                                           |    |    |
|---------|-------------------------------------------|----|----|
| Dec. 31 | Interest Receivable .....                 | 15 |    |
|         | Interest Revenue .....                    |    | 15 |
|         | <i>To record accrued interest earned.</i> |    |    |

# Recording End-of-Period Interest Adjustments

|                            |           |                  |
|----------------------------|-----------|------------------|
| Days in December           | 31        |                  |
| Minus the date of the note | <u>16</u> |                  |
| Day remaining in December  |           | 15               |
| Days in January            |           | 31               |
| Days in February           |           | <u>14</u>        |
| Period of the note in days |           | <u><u>60</u></u> |



## Recording collection on note at maturity.

|         |                                                   |       |       |
|---------|---------------------------------------------------|-------|-------|
| Feb. 14 | Cash .....                                        | 3,060 |       |
|         | Interest Revenue .....                            |       | 45    |
|         | Interest Receivable .....                         |       | 15    |
|         | Notes Receivable .....                            |       | 3,000 |
|         | <i>Received payment of note and its interest.</i> |       |       |

$$\$3,000 \times 12\% \times 60/360 = \$60$$

# Disposal of Receivables

Companies can convert receivables to cash before they are due.

**Selling  
Receivables**

**Pledging  
Receivables**

# Accounts Receivable Turnover

This ratio provides useful information for evaluating how efficient management has been in granting credit to produce revenue.

$$\frac{\text{Net sales}}{\text{Average accounts receivable, net}}$$

| Company | Figure (\$ millions)                      | 2008        | 2007        | 2006        | 2005        |
|---------|-------------------------------------------|-------------|-------------|-------------|-------------|
| Dell    | Net sales .....                           | \$61,101    | \$61,133    | \$57,420    | \$55,788    |
|         | Average accounts receivable, net .....    | \$ 5,346    | \$ 5,292    | \$ 4,352    | \$ 3,826    |
|         | <b>Accounts receivable turnover</b> ..... | <b>11.4</b> | <b>11.6</b> | <b>13.2</b> | <b>14.6</b> |
| Apple   | Net sales .....                           | \$32,479    | \$24,006    | \$19,315    | \$13,931    |
|         | Average accounts receivable, net .....    | \$ 2,030    | \$ 1,445    | \$ 1,074    | \$ 835      |
|         | <b>Accounts receivable turnover</b> ..... | <b>16.0</b> | <b>16.6</b> | <b>18.0</b> | <b>16.7</b> |



## Recognition of Receivables

Both U.S. GAAP and IFRS have similar asset criteria that apply to recognition of receivables. Further, receivables that arise from revenue-generating activities are subject to broadly similar criteria for U.S. GAAP and IFRS.

## Valuing of Receivables

Both U.S. GAAP and IFRS require that receivables be reported net of estimated uncollectibles. Further, both systems require that the expense for estimated uncollectibles be recorded in the same period when any revenues from those receivables are recorded.

## Disposition of Receivables

Both U.S. GAAP and IFRS apply broadly similar rules in recording dispositions of receivables.

# Thank You