

Financial Accounting

Prepared by Dr. Sara Ahmed

MGM 611

Lecture 6





مجموعة جامعة
الجميع الذكية
للتعليم القابضة

MIDOCEAN
UNIVERSITY
BY EVERYONE'S SMART UNIVERSITY

Accounting for Receivables

Lecture 6

MGM 611

Prepared by
Dr. Sara Ahmed

www.midocean.ae

TOPIC
06

LEARNING OBJECTIVES

- Describe accounts receivable and how they occur and are recorded.
- Explain how receivables can be converted to cash before maturity.
- Compute accounts receivable turnover and use it to help assess financial condition.
- Apply the direct write-off method to accounts receivable.
- Apply the allowance method to accounts receivable.
- Estimate uncollectibles based on sales and accounts receivable.

Learning Objective

Describe accounts receivable and how they occur and are recorded.

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>		

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

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

Exhibit 9.

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>

Sales on Store Credit Card

On November 1, TechCom recorded sales on their own credit card in the amount of \$1,000.

On December 31, TechCom recorded an adjusting entry for the interest earned at the rate of 1.5% per month on seller credit card.

Nov. 1	Accounts Receivable	1,000	
	Sales		1,000
	<i>Record sales on store credit card.</i>		
Dec. 31	Accounts Receivable	15	
	Interest Revenue		15
	<i>Interest of 1.5% earned on store card sales past due.</i>		

Sales on Bank Credit Card

On July 15, 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	
	<i>Record credit card sales less a 4% credit card expense.*</i>	

* We omit the entry to Dr. Cost of Sales and Cr. Merchandise Inventory to focus on credit card expense.

Sales on Installment

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.

Learning Objective

Apply the direct write-off method to accounts receivable.

Direct Write-Off Method

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 - Recording and Writing Off Bad Debts

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

Expense recognition principle requires expenses to be reported in the same accounting period as the sales they helped produce.

Materiality constraint 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.

Learning Objective

Apply the allowance method to accounts receivable.

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.

Allowance Method - 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		
Dec. 31	20,000	

Allowance for Doubtful Accounts		
	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

Current assets

Accounts receivable (net of \$1,500 doubtful accounts)	\$18,500
--	----------

Allowance Method – Writing Off a Bad Debt

TechCom has determined 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			
Dec. 31	20,000	Jan. 23	520

Allowance for Doubtful Accounts			
Jan. 23	520	Dec. 31	1,500

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>
Realizable value of accounts receivable	<u>\$18,500</u>	<u>\$18,500</u>

Allowance Method - Recovering a Bad Debt

To help restore credit standing, a customer sometimes pays 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>		

Learning Objective

Estimate uncollectibles
based on sales and
accounts receivable.

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:

	Current Period Sales
×	Bad Debt %
=	Estimated Bad Debts Expense

Percent of Sales Method

Musicland has credit sales of \$400,000 in 2017. It is estimated that 0.6% of credit sales will eventually prove uncollectible.

Let's look at recording Bad Debts Expense for 2017.

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

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

Compute the estimate of the Allowance for Doubtful Accounts.

Year-end Accounts Receivable x Bad Debt %
Bad Debts Expense is computed as:

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

Percent of Receivables Method

Musicland has \$50,000 in accounts receivable and a \$200 credit balance in Allowance for Doubtful Accounts on December 31, 2017. 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		
	Dec. 31, 2016, bal.	2,200
Feb. 6	800	
July 10	700	
Nov. 20	500	
	Unadjusted bal.	200
	Dec. 31 adjustment	2,300
	Dec. 31, 2017, bal.	2,500

Dec. 31*	Bad Debts Expense	2,300	
	Allowance for Doubtful Accounts		2,300
	<i>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, 2017						
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.....	\$ 5,890	\$ 5,890				
Jamie Allen.....	710			\$ 710		
Chavez Andres.....	10,500	10,300	\$ 200			
Balicia Company.....	2,800				\$1,900	\$ 900
Texas Rawhide.....	9,100		6,110	2,990		
Zamora Services.....	21,000	20,810	190			
Total receivables.....	\$50,000	\$37,000	\$6,500	\$3,700	\$1,900	\$ 900
Percent uncollectible.....		x 2%	x 5%	x 10%	x 25%	x 40%
Estimated uncollectible...	\$ 2,270	\$ 740	\$ 325	\$ 370	\$ 475	\$ 360

Each receivable is grouped by how long it is past its due date.

Each age group is multiplied by its estimated bad debts percent.

Estimated bad debts for each group are totaled.

Aging of Accounts Receivable

Step 1: Determine what current balance equals: \$200 credit.

Step 2: Determine what the account balance should be: \$2,270.

Step 3: Make adjusting entry to get from step 1 to step 2:
 $\$2,270 - 200 = \$2,070$.

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.		

Aging of Accounts Receivable

Step 1: Determine what current balance equals: \$500 debit.

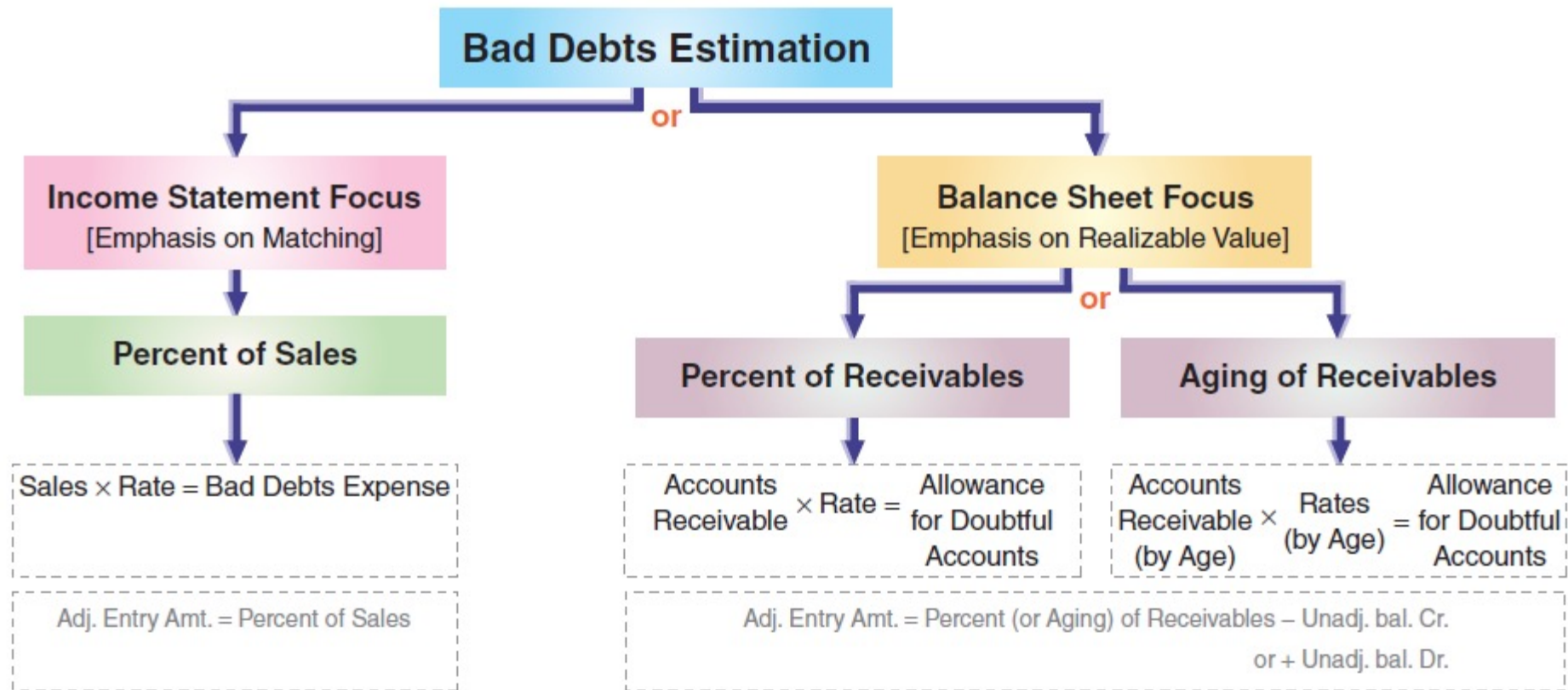
Step 2: Determine what the account balance should be: \$2,270.

Step 3: Make adjusting entry to get from step 1 to step 2:
 $\$2,270 + 500 = \$2,770$.

Allowance for Doubtful Accounts	
500	
	2,770
	2,270

Dec. 31	Bad Debts Expense	2,770	
	Allowance for Doubtful Accounts		2,770
	Record estimated bad debts.		

Summary of Methods



Learning Objective

Explain how receivables can be converted to cash before maturity.

Disposal of Receivables

Companies can convert receivables to cash before they are due.

**Selling
Receivables**

**Pledging
Receivables**

Learning Objective

Compute accounts receivable turnover and use it to help assess financial condition.

Accounts Receivable Turnover

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

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

Company	Figure (\$ millions)	2015	2014	2013	2012
IBM	Net sales.....	\$81,741	\$92,793	\$98,367	\$102,874
	Average accounts receivable, net.....	\$ 8,712	\$ 9,778	\$10,566	\$ 10,923
	Accounts receivable turnover.....	9.4	9.5	9.3	9.4
Oracle	Net sales.....	\$38,226	\$38,275	\$37,180	\$ 37,121
	Average accounts receivable, net.....	\$ 5,618	\$ 6,068	\$ 6,213	\$ 6,503
	Accounts receivable turnover.....	6.8	6.3	6.0	5.7



مجموعة جامعة
الجميع الذكية
للتعليم القابضة

MIDOCEAN
UNIVERSITY
BY EVERYONE'S SMART UNIVERSITY



Thank You

