

## Chapter 8

### Accounts Receivable



#### Accounts Receivable

Represents the amount due from the sale of goods or services to a customer. Typically, the entity expects to receive payment (i.e., cash) for the receivable within 30 days of the sale. If not, it will assess interest on the amount past due.



#### Other Receivables

- Nontrade, including interest receivable, loans to company officers, advances to employees, and income tax refunds.



### Receivables

The term receivables refers to amounts due from individuals and companies.

Receivables are frequently classified as:

- Accounts receivable
- Notes receivable
- Other receivables



#### Notes Receivable

- Represent a claim for which a formal instrument of credit is issued as evidence of the debt.
- Credit instrument normally requires **payment of interest** and extends for time periods of 60-90 days or longer.



#### Valuing Accounts Receivable

Although a company enters into a credit sales transaction with the intention of collecting the full amount of the sale, the economic reality is that the company will not collect on all of its credit sales. Therefore, to ensure that receivables are not overstated on the balance sheet, GAAP requires that an entity's receivables are stated at their **(net) realizable value**. To do this, a company must reduce the amount of its receivable by the amount it estimates it will not collect.



## Allowance for Doubtful Accounts

GAAP requires that an entity report the total amount of its accounts receivable – sometimes referred to as its gross receivables – as well as the amount that it determines it will not collect. The amount an entity determines it will not collect is referred to as an **allowance for doubtful accounts**. An example of the accounts receivable section of entity is:

Accounts receivable	\$1,200,000
Allowance for doubtful accounts	<u>(45,000)</u>
Accounts receivable net	\$1,155,000



## Allowance for Doubtful Accounts

Since the amount of the allowance for doubtful accounts is shown in the asset section of the balance sheet as a reduction of the asset accounts receivable, this allowance account is classified as a **contra-asset account** (i.e., an asset account with a credit balance).



## Allowance for Doubtful Accounts

The amount of the accounts receivable that will be uncollectible may be estimated using one of two methods:

- Percentage of sales (Income Statement)
- An aging of the accounts receivable (Balance Sheet)



## Percentage of Sales Method

This method is an income statement approach, since the amount of the bad debt is based on sales (i.e., an income statement item). Thus, if a company wants to smooth earnings, this method will achieve this result, since the amount added to the account is consistent with sales. Thus, this method does not necessarily mimic the actual default rate of the receivables still owed to the entity, since the estimate was only based on the entity's gross sales and not its actual remaining receivables.



## Example: Percentage of Sales Method

If Rhody has sales of \$2,000,000 for the year and bad debts is estimated to be 1% of sales, what is the amount needed to be added to the allowance account?



## Percentage of Sales

The allowance account is increased by \$20,000 ( $\$2,000,000 \times 1\%$ ) and represents the amount Rhody does not think it will collect.

### Journal Entry:

Bad Debt Expense	20,000
Allowance for Doubtful Accounts	20,000



## Allowance Method Aging of Receivables

Under a balance sheet allowance method, the amount added to the allowance account is calculated using an aging of the accounts receivable. Receivables are generally expected to be collected within 30 days from the date of sale. An aging breaks down the receivables into current (i.e., due within 30 days of the date of sale) and subsequent 30-day increments of when the receivable is expected to be collected (i.e., past due amounts) .



## Allowance Method: Aging of Receivables

Therefore, the first range of an aging schedule after current is 0-30 days past due, the next range would be receivables that are 31-60 days past due, then 61-90 past due, then 91-120 days past due, then 121-150 days past due, then receivables that are over 150 days past due. Obviously, the longer the past due the greater the likelihood the sale will not be collected. Thus, the percentage amount of the receivable that will be uncollected increases.



## Allowance Method: Aging of Receivables

For example, if Rhody thought that it would only collect 30% of all receivables that are over 150 days past due and it had \$8,000 of receivables that are over 150 days past due, what amount of these receivables would Rhody expect to be uncollectible?



## Allowance Method: Aging of Receivables

Rhody would expect to have \$2,400 ( $\$8,000 \times 30\%$ ) of these receivables (i.e., 150 days past due) become uncollectible.



## Allowance Method: Aging of Receivables

When a company uses this method, it summarizes the total amount of all its uncollectibles from its aging schedule and that becomes the amount of the allowance for doubtful accounts.



## Example: Aging of Receivables

Assume that at year-end, before it completes its aging of its accounts receivable, Rhody has \$7,000 in the allowance for doubtful accounts from the previous year. At year-end, after it completes its aging of the accounts receivable, Rhody estimates that it will not collect \$24,000 of its \$300,000 of accounts receivable. What is the amount Rhody should add to the allowance for doubtful accounts?



## Allowance Method: Aging of Receivables

Rhody will need to increase the allowance account by \$17,000 (24,000 - \$7,000). Why is this different than using percentage of sales? Because unlike the percentage of sales method that uses an income statement approach, the aging is based on actual receivables.

### Journal Entry:

Bad Debt Expense	17,000	
Allowance for Doubtful Accounts		17,000



## Actual Uncollectible

Now what happens if a receivable becomes uncollectible? Remember, what we have just done is only an estimate!! We will have to remove the amount of the receivable from our books by crediting accounts receivable and reducing the amount we have set aside as an allowance by debiting the allowance for doubtful accounts. The effect – assuming that the uncollected accounts receivable is not larger than the allowance for doubtful accounts – is that net accounts receivable doesn't change. Rather both the gross accounts receivable and allowance for doubtful accounts are reduced.



## Example: Actual Uncollectible

Assume that Rhody has \$300,000 of accounts receivables and an allowance for doubtful accounts of \$24,000. It now determines that a \$5,000 accounts receivable will not be collected. What impact does this have on the financial statements?



## Example: Actual Uncollectible

The write-off of the accounts receivable has no direct impact on the financial statements. It only has informational impact. Since we were being conservative by recognizing as an expense an estimated amount that will become uncollectible, when the actual amount becomes known, it only serves to adjust the gross amount of accounts receivable and the allowance for doubtful accounts and has no income statement or **net** balance sheet impact.



## Example: Actual Uncollectible

The actual journal entry to account for the uncollectible is:

Allowance for Doubtful Accounts	5,000	
Accounts Receivable		5,000



## Example: Actual Uncollectible

### Net Accounts Receivable Before:

Accounts receivable gross	\$300,000
Allowance for doubtful accounts	<u>(24,000)</u>
Accounts receivable net	\$276,000

### Net Accounts Receivable After:

Accounts receivable gross	\$295,000
Allowance for doubtful accounts	<u>(19,000)</u>
Accounts receivable net	\$276,000



## Balance Sheet Disclosure of Receivables

- Receivables are reported in the current asset section of the balance sheet after short-term investments (i.e., marketable securities).
- Both the gross amount of receivables and the allowance for doubtful accounts should be reported.
- Generally, only accounts receivable is disclosed, since the other types of receivables are not material. In some cases, the other types of receivables are disclosed in the notes to the financial statements.



## Income Statement Disclosures from Receivables

Bad Debts Expense is reported as a part of selling and administration expense in the income statement. Thus, it is hard to determine the exact amount.



## How to Successfully Manage Receivables

- **Determine to whom to extend credit** through a company credit check. Dun & Bradstreet is a company that provides this service.
- **Establish a payment period** and charge interest for customers who do not pay on time
- **Monitor collections** through continual aging of receivables. This prevents extending credit to someone with receivables more than 30 days past due.



## Evaluating the Receivables Balance

Liquidity is measured by how quickly certain assets can be converted into cash. The ratio used to assess the liquidity of the receivables is the **receivables turnover ratio**. This ratio measures the number of times, on average, receivables are collected during the period.



## Evaluating the Receivable Balance

The receivables turnover ratio is:

$$\frac{\text{net credit sales (net sales less cash sales)}}{\text{average receivables}}$$

Average collection period in terms of days:

$$\frac{365 \text{ days}}{\text{receivables turnover ratio.}}$$

The collection period should not greatly exceed the credit term period (i.e., 30 days).

