REPORTING AND ACCOUNTS RECEIVABLE

LO 1: Explain how companies recognize accounts receivable.

RECEIVABLES

- "Amounts due from individuals and companies that are expected to be collected in cash."
    1. **<u>Accounts Receivable</u>:** Amounts customers owe on account that result from the sale of goods and services. Companies generally expect to collect accounts receivable within 30 to 60 days.

    2. **<u>Notes Receivable:</u>** Written promise (formal instrument) for amount to be received. Also called **trade receivables**. They include interest and extend for time periods of **60 to 90 days or longer**.

    3. **<u>Other Receivables</u>**: Nontrade receivables such as interest, loans to officers, advances to employees, and income taxes refundable.

- Service organization records a receivable when it performs service **ON ACCOUNT**.
- Merchandiser records accounts receivable at the point of sale of merchandise **ON ACCOUNT**.

*****Below are examples of journal entries that would be made with accounts receivables. Many of these journal entries were explained in Chapter 5.**

			DEBIT	CREDIT
SELLER	1. Selling Merchandise ON ACCOUNT (**2 Journal Entries**- Record **sale** and to show a decrease in **inventory sold.**)	Accounts Receivable	xxx	
		Sales Revenue		xxx
		Cost of Goods	xxx	
		Inventory		xxx
	2. Receiving payment **<u>WITHIN</u>** the discount period.	Cash	xxx	
		Sales Discounts	xxx	
		Accounts Receivable		xxx
	3. Receiving payment **<u>OUTSIDE</u>** the discount period.	Cash	xxx	
		Accounts Receivable		xxx
	4. Granting Sales Returns or Allowances (**2 Journal Entries**)	Sales Returns and Allowances	xxx	
		Accounts Receivable		xxx
		Inventory	xxx	
		Cost of Goods		xxx
	5. **Adjusting entry** for interest charges that companies add to the amount customers owe at the end of the month.	Accounts Receivable	xxx	
		Interest Revenue		xxx

<u>Example</u>: Prepare journal entries to record the following transactions entered into by the **Castagno Company**:

Nov. 1 Sold merchandise on account to Mercer, Inc., for $18,000, terms 2/10, n/30.
Nov. 5 Mercer, Inc., returned merchandise worth $1,000.
Nov. 9 Received payment in full from Mercer, Inc.

	Date	Debit	Credit
Accounts Receivable- Mercer, Inc.	**Nov. 1**	18,000	
Sales Revenue			18,000
Sales Returns and Allowances	**Nov. 5**	1,000	
Accounts Receivable- Mercer, Inc.			1,000
Cash	**Nov. 9**	16,660	
Sales Discounts ($17,000 x 0.02)		340	
Accounts Receivable- Mercer, Inc.			17,000

*****Remember: 2/10, n/30 means that the buyer (Mercer) will get a 2% discount on the selling price if they pay Castagno within 10 days, otherwise the full amount is due in 30 days with no discount.**

LO 2: Describe how companies value accounts receivable and record their disposition.

VALUING ACCOUNTS RECEIVABLE

- Current asset on the balance sheet.
- Valuation (net realizable value). **(The amount of accounts receivable that the company actually expects to collect.)**
- **Bad Debt Expense:** Losses that the seller records as a result from extending credit and not being able to collect the money.

- Two methods used in accounting for uncollectible accounts are:
    1. **Direct Write-Off Method**
        - Records bad debt expense only when an account is determined to be worthless.
        - Used by SMALL companies and companies with a FEW receivables.
        - No matching.
        - Receivable is not stated at net realizable value.
        - Not acceptable for financial reporting.
        - If an accounts receivable that has been written off is later collected, then 2 journal entries have to be made. One to *reinstate the accounts receivable* and the other one to *collect the cash*.

    2. **Allowance Method**
        - Records bad debt expense by estimating uncollectible accounts at the end of the accounting period.
        - Generally accepted accounting principles (GAAP) require companies with a large amount of receivables to use the allowance method.
        - When an estimation of bad debts is made the account **"ALLOWANCE FOR DOUBTFUL ACCOUNTS"** gets credited (Has a **normal CREDIT balance** after the end of period adjusting journal entry). It is a contra-asset.
            - Allowance for Doubtful accounts has a **DEBIT balance** when:
              the write-offs during the period EXCEED than the beginning balance.
            - Allowance for Doubtful accounts has a **CREDIT balance** when:
              write-offs during the period are LESS than the beginning balance.

Cash (Net) Realizable Value of Receivables= Accounts Receivable Balance – Allowance for Doubtful Accounts

Write-Off of Accounts Recievable Journal Entries

	Direct Write-Off Method			Allowance Method		
	Account Title	**Debit**	**Credit**	**Account Title**	**Debit**	**Credit**
1. Write-off accounts recievable as uncollectible.	Bad Debt Expense	XXX		Allowance for Doubtful Accounts	XXX	
	Accounts Receivable		XXX	Accounts Receivable		XXX
2. (a) Reinstate accounts recievable. (b) Subsequent collection of cash.	**(a) Account Title**	**Debit**	**Credit**	**(a) Account Title**	**Debit**	**Credit**
	Accounts Receivable	XXX		Accounts Receivable	XXX	
	Bad Debt Expense		XXX	Allowance for Doubtful Accounts		XXX
	(b) Account Title	**Debit**	**Credit**	**(b) Account Title**	**Debit**	**Credit**
	Cash	XXX		Cash	XXX	
	Accounts Receivable		XXX	Accounts Receivable		XXX
3. Estimation of allowance of doubtful accounts at year-end.	NO JOURNAL ENTRY			**Account Title**	**Debit**	**Credit**
				Bad Debt Expense	XXX	
				Allowance for Doubtful Accounts		XXX

<u>Example</u>: On November 15, it was determined that Mr. Sanders account of $3,000 would be uncollectible. On December 20, after Mr. Sanders account was written off he paid Company M $3,000 in full. On December 31, Company M estimated that $10,000 of their remaining credit sales will prove uncollectible.

a) Prepare the journal entries for November 15, December 20, and December 31 under the ***direct write-off method***.

	Date	Debit	Credit
Bad Debt Expense	**Nov. 15**	3,000	
Accounts Receivable- Mr. Sanders			3,000
Accounts Receivable- Mr. Sanders	**Dec. 20**	3,000	
Bad Debt Expense			1,000
Cash	**Dec. 20**	3,000	
Accounts Receivable- Mr. Sanders			3,000
NO JOURNAL ENTRY	**Dec. 31**		

b) Prepare the journal entries for November 15, December 20, and December 31 under the ***allowance method***.

	Date	Debit	Credit
Allowance for Doubtful Accounts	**Nov. 15**	3,000	
Accounts Receivable- Mr. Sanders			3,000
Accounts Receivable- Mr. Sanders	**Dec. 20**	3,000	
Allowance for Doubtful Accounts			1,000
Cash	**Dec. 20**	3,000	
Accounts Receivable- Mr. Sanders			3,000
Bad Debt Expense	**Dec. 31**	10,000	
Allowance for Doubtful Accounts			10,000

PRESENTATION OF ACCOUNTS RECIEVABLE ON THE BALANCE SHEET UNDER THE ALLOWANCE METHOD

HAMPSON FURNITURE
Balance Sheet (partial)

Current assets		
Cash		$ 14,800
Accounts receivable	**$200,000**	
Less: Allowance for doubtful accounts	**12,000**	**188,000**
Inventory		310,000
Supplies		25,000
Total current assets		$537,800

- **Cash (Net) Realizable Value** = Accounts Receivable – Allowance for Doubtful Accounts
- For Hampson Furniture, of the $200,000 in Accounts Receivable, they only expect to collect $188,000. They do not expect to collect $12,000.

2 Methods for Estimating Uncollectible Accounts under the Allowance Method

1. Balance Sheet Approach (Percent of Ending Accounts Receivable Method)

Allowance for Doubtful Accounts

	BEG Balance
	$\boxed{*X}$-- WE NEED TO FIGURE THE ADJUSTMENT FROM THE BEG TO END BALANCE
	Y- END BALANCE

% of End Accounts Receivable as Uncollectible as a decimal x End A/R = Y

JOURNAL ENTRY

Bad Debt Expense	**$\boxed{X}$**	
Allowance for Doubtful Accounts		**$\boxed{X}$**

RULES

1. IF BEGINNING ALLOWANCE FOR DOUBTFUL ACCOUNTS IS A CREDIT THEN
END BALANCE – BEGINNING BALANCE = $\boxed{X}$

2. IF BEGINNING ALLOWANCE FOR DOUBTFUL ACCOUNTS IS A DEBIT THEN
END BALANCE + BEGINNING BALANCE = $\boxed{X}$

Ex: 1 *Smith Inc. estimates that 1% of their $100,000 accounts receivable balance as of December 31 will be uncollectible. What Journal entry would be made on December 31 if the beginning balance for the Allowance for Doubtful Accounts was a **$600 CREDIT balance**?*

Bad Debt Expense	**$\boxed{400}$**		**$1,000 (END) - $600 (BEG)**
Allowance for Doubtful Accounts		**$\boxed{400}$**	**$1,000 (END) - $600 (BEG)**

Allowance for Doubtful Accounts

	$600 Beginning Balance	
	$\boxed{\$400}$	**$1,000 (END) - $600 (BEG) = $400**
	$1,000	**0.01 X $100,000 = $1,000**
	Ending Balance	

<u>Ex: 2</u> *Smith Inc. estimates that 1% of their $100,000 accounts receivable balance as of December 31 will be uncollectible. What Journal entry would be made on December 31 if the beginning balance for the Allowance for Doubtful Accounts was a* ***<u>$600 DEBIT balance</u>****?*

	Debit	Credit	
Bad Debt Expense	**1,600**		**$1,000 (END) + $600 (BEG)**
Allowance for Doubtful Accounts		**1,600**	**$1,000 (END) + $600 (BEG)**

<u>Allowance for Doubtful Accounts</u>

Debit	Credit	
BEG: $600	$1,600	**$1,000 (END) + $600 (BEG) = $1,600**
	End: $1,000	**0.01 X $100,000 = $1,000**

2. Balance Sheet Approach (Aging the Accounts Receivables Method)

Aging of Recievables Method		Totals	Not Yet Due	1-30 days Past Due	31-60 days Past Due	61-90 days Past Due	90 + Days Past Due
	John Smith	$2,000		$1,000		$1,000	
	Sue	$3,000	$1,000	$1,000	$1,000		
	Jim	$10,000	$5,000		$2,000	$1,000	$2,000
	Total Recievables	$15,000	$6,000	$2,000	$3,000	$2,000	$2,000
	Percent Uncollectible		2%	5%	10%	25%	40%
	ESTIMATED UNCOLLECTIBLE	**$1,820.00**	$120	$100	$300	$500	$800

Ending Balance of Allowance for Doubtful Accounts

***If Allowance for Doubtful Accounts had an unadjusted $500 credit balance then…..**

Ending Balance – Beginning Balance = Adjustment

$1,820 - $500 = $1,320

	Debit	Credit
Bad Debt Expense	**1,320**	
Allowance for Doubtful Accounts		**1,320**

*The amount of the adjusting entry is the amount that will yield an adjusted balance for Allowance for Doubtful Accounts equal to that estimated by the aging schedule. In this case the adjusted entry which CREDITS Allowance for Doubtful Accounts by $1,320 leads to the ending adjusted balance of the Allowance for Doubtful Accounts to have a CREDIT balance of $1,820.

DISPOSING OF ACCOUNTS RECEIVABLE

Sale of Receivables to a Factor

- A **factor** is a finance company or bank.
  - Buys receivables from businesses and then collects the payments directly from the customers.
  - Typically charges a commission to the company that is selling the receivables.
  - Fee ranges from 1% to 3% of the receivables purchased.

Ex: Assume that Hendredon Furniture factors $600,000 of receivables to Federal Factors on Nov. 15. Federal Factors assesses a service charge of 2% of the amount of receivables sold. The journal entry to record the sale by Hendredon Furniture is as follows:

	Date	Debit	Credit
Cash	**Nov. 15**	588,000	
Service Charge Expense ($600,000 x 2%)		12,000	
Accounts Receivable			600,000

National Credit Card Sales (Customers that use Visa, Mastercard, or other credit card)

- A retailer's acceptance of a national credit card is another form of selling (factoring) the receivables by the retailer.
  - Retailer pays card issuer a fee of 2 to 4% of the invoice price for its services.
  - **Recorded the same as cash sales**.
  - **Advantages to retailer**:
    - Issuer does credit investigation of customer.
    - Issuer maintains customer accounts.
    - Issuer undertakes collection and absorbs losses.
    - Receives cash more quickly.

Ex: Chef Louie purchases $2,000 worth of food and ingredients for his restaurant from Frank's Fresh Market store, and he charges this amount on his MasterCard. The service fee that MasterCard charges Frank's Fresh Market is 4%. Frank's Fresh Market would record this transaction on March 28 as follows:

	Date	Debit	Credit
Cash	**Mar. 28**	1,920	
Service Charge Expense ($2,000 x 4%)		80	
Sales Revenue			2,000

LO 3: Explain how companies recognize, value, and dispose of ***Notes Receivable***.

Promissory Note: "written promise to pay a specified amount of money on demand or at a definite time."

- Promissory notes may be used when
    1. Individuals and companies lend or borrow money.
    2. Amount of transaction and credit period exceed normal limits.
    3. In settlement of accounts receivable.
- Used for a credit period of more than 60 days. If it is going to be collected ***WITHIN ONE YEAR***, it is classified as a **current asset** on the **balance sheet**. If it is going to be collected **AFTER MORE THAN A YEAR**, then it is classified as a **noncurrent asset as an investment** on the **balance sheet**.
- Report short-term notes receivable at their cash (net) realizable value.
- Estimation of cash realizable value and recording bad debt expense and related allowance are similar to accounts receivable.

EXAMPLE used for terms below: A NOTE DATED JUNE 20, 20XX FOR **RON** TO PAY CAM *$1,000* ON OCTOBER 20, 20XX WITH AN INTEREST RATE OF 10%.

1. **Face Value of a Note (Principal):** specified amount of money at a definite future date. (Ex: *$1,000*)

2. **Maker of the Note:** the person who signed the note and promised to pay it at maturity. (Ex: **RON**)
    - The maker of the note recognizes a **note payable.**

3. **Payee of the Note:** the person to whom the note is payable. (Ex: CAM)
    - The payee of the note recognizes a **note receivable**.

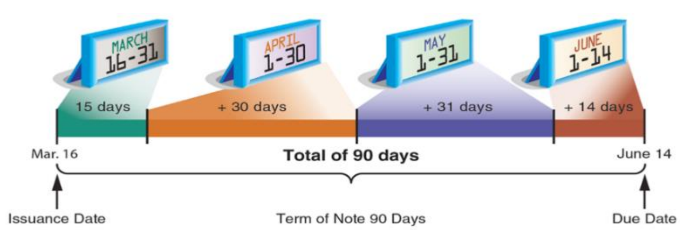
4. **Issuance Date**: the date the note is issued. (Ex: JUNE 20, 20XX)

5. **Maturity date of the Note:** the date the note must be repaid. (Ex: OCTOBER 20, 20XX)
    - May be stated **on demand**, on a **stated date**, or at the end of a **stated period of time**.
    - Note terms are expressed in **months** and **days**.

*When months or years are used, the note matures and is payable in the month of its maturity on the same day of the month as its original date. For example, a 9-month note dated September 28 would be payable on June 28.

*If days, then have to count days in the month. DON'T INCLUDE DATE OF NOTE AS PART OF NUMBER OF DAYS. For example, if note issued March 16 the amount of days note is outstanding in **March is 31 days – 16 = 15 days**.

Term of Note		**90 days**
March (31-16)	15 days	
April	30 days	
May	31 days	76
June		**14**
(Maturity Date)		



6. **Term of Note:** amount of time between the issuance and due dates. (About 122 days—Time between June 20, 20XX and October 20, 20XX)

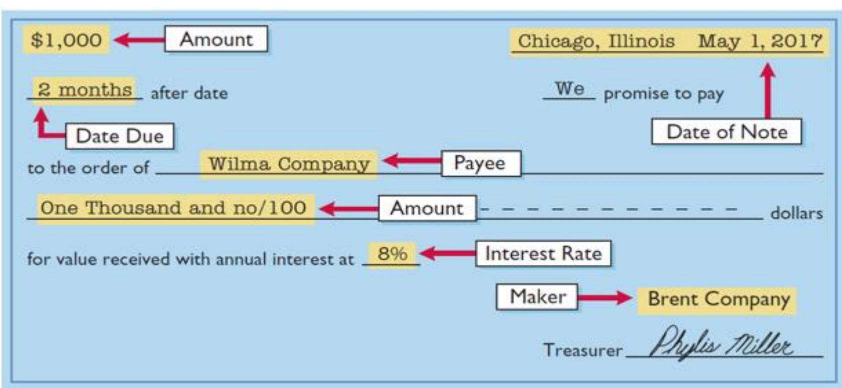
7. **Interest Computation:** Face Value of Note × Annual Interest Rate × Time in Terms of One Year = Interest

<u>**Time in Terms of One Year**</u>
Days: **# of days ÷ 360**
Months: **# of months ÷ 12**
Years: **# of years ÷ 1**

Ex: The total interest for a $1,000, 90-day, and 10% note would be computed as follows:
$1,000 X 10% X (90/360) = ***$25***

Current Example: 122 day note between Ron and Cam.
$1,000 x 10% x (122/360) = **$33.89 Interest**

8. **Maturity Value:** Amount that must be paid at the due date of the note. It is the sum of the face amount and interest. In our example Ron has to pay Cam ***$1,033.89*** ($1,000 Face Amount + $33.89 Interest) when note is due on October 20, 2017.



Another Note Example with Terms

Journal Entries for Notes Receivable

PAYEE			DEBIT	CREDIT
	1. Coverting an accounts recievable into a notes recievable to settle an open account.	Notes Receivable	xxx	
		Accounts Receivable		xxx
	2. **Honor of notes receivable** which is when the maker pays it full at maturity.	Cash	xxx	
		Notes Receivable		xxx
		Interest Revenue		xxx
	3. **Dishonored note** which occurs when the maker does not pay the note in full at maturity.	Accounts Receivable	xxx	
		Notes Receivable		xxx
		Interest Revenue		xxx
	4. Accrual of interest (to account for the interest earned during the period, but not paid out.)	Interest Receivable	xxx	
		Interest Revenue		xxx
	5. Honoring the note AFTER accrual of interest in prior accounting period.	Cash	xxx	
		Notes Receivable		xxx
		Interest Receivable		xxx
		Interest Revenue		xxx

1. Recognizing Notes Receivable (Tropical Breeze-Payee point of view)

Tropical Breeze Inc. received a $2,000, 90-day, 10% promissory note from Paradise Sand to settle their overdue open account.

Notes Receivable- Paradise Sand	2,000	
Accounts Receivable- Paradise Sand		2,000

2. Recording an Honored Note (Tropical Breeze-Payee point of view)

After 90 days, Tropical Breeze Inc. receives $2,050 from Paradise Sand ($2,000 to repay the note and $50 in interest.) **Interest = (2,000 x 10% x (90/360))= $50**

Cash	2,050	
Notes Receivable- Paradise Sand		2,000
Interest Revenue		50

3. Recording a Dishonored Note (Tropical Breeze-Payee point of view)

After 90 days, Paradise Sand is unable and refuses to pay Tropical Breeze Inc. $2,050 ($2,000 to repay the note and $50 in interest.)

Accounts Receivable- Paradise Sand	2,050	
Notes Receivable- Paradise Sand		2,000
Interest Revenue		50

4. Recording End-of-Period Interest Adjustment (Tropical Breeze-Payee point of view)

If Tropical Breeze Inc. receives a $2,000, 90-day, 10% promissory note from Paradise Sand on December 1, then on December 31 Tropical Breeze Inc. would need to recognize 30 days of interest.

$2,000 X 10% X (30/360) = $16.67

Interest Receivable	16.67	
Interest Revenue		16.67

LO 4: Describe the statement presentation of receivables and the principles of receivables management.

Real World

DEERE & COMPANY
Balance Sheet (partial)
(in millions)

Receivables	
Receivables from unconsolidated subsidiaries	$ 30
Trade accounts and notes receivable	3,278
Financing receivables	27,583
Restricted financing receivables	4,616
Other receivables	1,500
Total receivables	37,007
Less: Allowance for doubtful trade receivables	175
Net receivables	$36,832

- Companies need to identify in the balance sheet or in notes to the financial statements each of the major types of receivables.
- Companies report both the gross amount of receivables and the allowance for doubtful accounts.

MANAGING RECEIVABLES

Managing accounts receivable involves five steps:

1. **Determine to whom to extend credit.**

2. **Establish a payment period.**

3. **Monitor collections.**
   - Companies should prepare an accounts receivable aging schedule at least monthly.
     - Helps managers estimate the timing of future cash inflows.
     - Provides information about the collection experience of the company and identifies problem accounts.

4. **Evaluate the liquidity of receivables.**

   - **<u>Accounts Receivable Turnover</u>:** Measure the number of times, on average, a company collects receivables during the period.

   $$\text{Accounts Receivable Turnover} = \frac{\text{Net Credit Sales}}{\text{Average Net Accounts Receivable}}$$

   - **<u>Average Collection Period</u>:** Used to assess the effectiveness of credit and collection polices. This period SHOULD NOT EXCEED credit term period.

   $$\text{Average Collection Period} = \frac{365}{\text{Accounts Receivable Turnover}}$$

5. **Accelerate cash receipts from receivables when necessary.**