CHAPTER 7
ACCOUNTING FOR RECEIVABLES

Key Terms and Concepts to Know

Accounts Receivable:

- Result from sales on account (credit sales), not cash sales.
- May also result from credit card sales if there is a delay between when sale is made and when the cash is received from the credit card company.

Accounting for Uncollectible Accounts:

- Not all sales on account result in cash being collected from the customer.
- Account receivable that are not collected result in an operating expense.
- The matching principle requires that this expense be recorded in the period of sale, not the period when the account is determined to be uncollectible.
- The Allowance Method is GAAP and fulfills the matching principle.
- The Direct Write-off Method is not GAAP and may not be used unless the expense closely approximates the expense under the Allowance Method.

Determining the Amount of Uncollectible Receivables and Bad Debt Expense:

- The Percent of Sales Method
  - Uses credit sales for the period to estimate bad debt expense for the period.
  - Sometimes referred to as the income statement method.
- The Percent of Receivables Method
  - Analyses the balance in Accounts Receivable to estimate the balance in the Allowance for Uncollectible Accounts at the end of the period.
  - Sometimes referred to as the balance sheet method.

Accounts Receivable on the Balance Sheet:

- Allowance account is deducted from Accounts Receivable to determine Net Realizable Value.

Notes Receivable:

- Notes Receivable may be accepted by the seller in payment for a sale or to replace an account receivable from a prior sale.
- Notes bear interest for their term which is paid at the end of the term, the maturity date.
- Interest rates are typically stated as a percent per annum, that is, as a yearly or annual rate.

- Interest revenue is earned as time passes, regardless of whether payment has been received.
- Interest revenue for outstanding notes receivable is typically accrued at the end of the year, although it may be accrued at the end of a quarter or month.
- If the note is not paid or dishonored at maturity, the amount of the principal and interest is debited to accounts receivable because it is still payable to the seller by the buyer. Another note may also be accepted by the buyer in place of the account receivable.

Accounts Receivable Turnover Ratio

Key Topics to Know

Allowance Method

The Allowance Method takes its name from the Allowance for Uncollectible Account which is used to properly value accounts receivable until the uncollectible account receivable can be written-off.

The Allowance Method debits bad debt expense in the period when the sale is recorded and credits a contra-asset account, Allowance for Uncollectible Accounts.

Uncollectible Accounts Expense	xxx	
Allowance for Uncollectible Accounts		xxx

In the period in which a specific account is determined to be uncollectible, the Allowance is debited and Accounts Receivable is credited.

Allowance for Uncollectible Accounts	xxx	
Accounts Receivable		xxx

Uncollectible Accounts Expense is reported on the Income Statement. The Allowance for Uncollectible (Doubtful) Accounts is a contra asset account and is reported on the Balance Sheet as a deduction from Accounts Receivable. The result is called Net Realizable Value:

Current Assets:	
Accounts Receivable	25,000
less allowance for doubtful accounts	3,000
Net Realizable Value	22,000

Sometimes a customer will pay the accounts receivable after it was written off. Recording the receipt of cash is always a two-step process: first, the account receivable is reinstated (added back into the general ledger) and second, the cash is recorded and accounts receivable is reduced for the payment.

To reinstate the accounts receivable:

Accounts Receivable	xxx	
Allowance for Uncollectible Accounts		xxx

To apply the cash received:

Cash	xxx	
Accounts Receivable		xxx

Example #1: Journalize the following transactions.

2011	12/31	Estimated that $7,000 of accounts receivable would become uncollectible.
2012	1/05	Wrote-off the $800 balance owed by Jane Camp and the $500 balance owed by Friends, Inc.
	3/18	Reinstated the account of Jane Camp that had been written off as Uncollectible

Solution #1

Uncollectible Accounts Expense	7,000	
Allowance for Uncollectible Accounts		7,000
Allowance for Uncollectible Accounts	1,300	
Accounts Receivable-Camp		800
Accounts Receivable-Friends		500
Accounts Receivable-Camp	800	
Allowance for Uncollectible Accounts		800
Cash	800	
Accounts Receivable-Camp		800

Methods for Estimating the Uncollectible Amount

In the period of sale, the customer that eventually will not pay, the amount that will not be paid and the period in which the customer's account will become uncollectible cannot be determined. Therefore, the uncollectible accounts expense must be estimated at the end of each accounting period.

Percentage of Sales Method

The Percent of Sales Method uses one income statement account, Sales, to estimate the change in another income statement account, Bad Debt Expense, for the period. This is the amount of the required adjusting entry. This method is typically used by businesses with a large number of customers with relatively uniform accounts receivable balances.

The balance in the Allowance account is the balance in the ledger before adjustment plus the adjusting entry for bad debt expense.

The bad debt expense for the period is calculated by multiplying the uncollectible percentage times the credit sales in the period to determine the uncollectible accounts expense for the period. This will be the amount of the adjusting entry.

Example #2: Uncollectible accounts expense is estimated at ¼ of 1% of net sales of $4,000,000 for the year. The current balance in Allowance for Doubtful Accounts is $300 credit. Determine the following:

a) The uncollectible accounts expense for the year.
b) The adjusting entry to be made on December 31.
c) The balance in Allowance for Doubtful Accounts after adjustment.

Solution #2

1. 4,000,000 * .0025 = $10,000
2. Uncollectible Accounts Expense 10,000

Uncollectible Accounts Expense	10,000	
Allowance for Uncollectible Accounts		10,000

3. $300 credit balance + 10,000 additional credit = $10,300 credit balance

Percent of Accounts Receivable Method

The Percent of Receivables Method uses the balance in one balance sheet account, Accounts Receivable, to estimate the balance in another balance sheet account, Allowance for Uncollectible Accounts, at the end of the period.

The adjusting entry for bad debt expense is the difference between the balance in the ledger for the allowance account before adjustment and the estimated balance in the allowance account.

The current balance of accounts receivable is analyzed by use of an aging schedule to determine the desired ending balance for the Allowance for Doubtful Accounts. The uncollectible accounts expense for the period is determined based on the current (unadjusted) balance in the Allowance, the desired ending balance in the Allowance account and any write-offs of uncollectible accounts during the period.

Allowance for Doubtful Accounts	
	Beginning balance
Write-offs	Solve for bad debt expense
	Ending balance

Bad debt expense = ending balance + write-offs – beginning balance

However, if there have been more write-offs than expected, the balance before adjustment in the allowance account may be a debit:

Allowance for Doubtful Accounts	
Beginning balance	
Write-offs	Solve for bad debt expense
	Ending balance

Bad debt expense = ending balance + write-offs+ beginning balance

<u>Example #3:</u> The balance of Allowance for Doubtful Accounts before adjustment at the end of the period is $400 debit. Based on an analysis of Accounts Receivable, it was estimated that $9,000 would become uncollectible.
Determine the following:

a) The uncollectible accounts expense for the year.
b) The adjusting entry to be made of December 31.
c) The balance in Allowance for Doubtful Accounts after adjustment.

Solution #3

a) Allowance for Doubtful Accounts

Balance 400	
	Uncollectible accounts expense = ?
Accounts receivable written-off = 0	
	9,000 ending balance

Uncollectible accounts expense = 400 + 9,000 -0 = 9,400

b)

Uncollectible accounts expense	9,400	
Allowance for doubtful accounts		9,400

c) 9,000

Practice Problem #1: Journalize the following transactions assuming the allowance method is used to account for uncollectible receivables.

05/14	Received 75% of the $20,000 balance owed by Webb Co., a bankrupt business. Wrote off remainder as uncollectible.
06/20	Reinstated the account of Zorn Co., which had been written off in the preceding year as uncollectible. Received $5,225 cash as full payment of Zorn's account.
07/27	Wrote off the $2,500 balance owed by Schmich, Inc. which had no assets.
12/31	Based on an analysis of Accounts Receivable, it is determined that $11,500 will become uncollectible. The balance in Allowance for Doubtful Accounts on December 31 prior to adjustment is $200 credit.

Determine the following:

a) The balance in Allowance for Doubtful Accounts after adjustment.
b) The Net Realizable Value of Accounts Receivable if the balance of Accounts Receivable is $62,000.
c) Redo the entry for 12/31and questions a) and b) if the percent of sales method had been used to estimate uncollectible accounts expense at the rate of ½ of 1% of net sales of $2,000,000.

DIRECT WRITE-OFF METHOD

The Direct Write-off Method records uncollectible accounts expense in the period when the customer's account is determined to be uncollectible. The entry to write-off the account receivable is

Uncollectible accounts expense	xxx	
Accounts receivable		xxx

in the period when a specific account is determined to be uncollectible. The Direct Write-off Method violates the matching principle because it does not match revenues and expenses in the same period.

NOTES RECEIVABLE

A Promissory Note is a written promise to pay a specific dollar amount on demand or at a specific time, usually with interest. If the note is paid according to the terms, the note is honored. If the note is not paid as agreed according to the terms, the note is dishonored. If the note is dishonored, the amount due including the interest earned and unpaid is recorded in accounts receivable.

At the end of the accounting period, in order to comply with the matching principle, interest must be accrued for the number of days between the most recent interest payment date and the end of the accounting period using the calculation method shown above.

Example #4: On July 17, 2001, received a $12,000, 90-day, 10% note on account from Adams Co.

Determine:

a) Due date for the note
b) Interest earned during the term of the note
c) Maturity value of the note

Prepare journal entries whether:

d) The note is honored on the maturity date
e) The note is dishonored on the maturity date

Solution #4:

a) Due Date:

Term of the note =	90
Days remaining in July 31 – 17 =	14
Remaining term of the note	76
Days in August	31
Remaining term of the note	45
Days in September	30
Remaining term of the note	15

Since the remaining 15 days are less than the 31 days in October, the note is due on October 15.

b) Interest:
Calculated as Principal X Rate X Time
$12,000 x .10 x 90 days/360 days = $300
Time is calculated as the term of the note divided by 360 days for the year.
Time is always based on a 360-day year.

c) Maturity Value:
Calculated as Principal + Interest
$12,000 + $300 = $12,300

d) Note is honored:

7/17	Notes receivable	12,000	
	Accounts receivable		12,000
10/15	Cash	12,300	
	Notes receivable		12,000
	Interest receivable		300

e) Note is dishonored:

7/17	Notes receivable	12,000	
	Accounts receivable		12,000
10/15	Accounts receivable	12,300	
	Notes receivable		12,000
	Interest receivable		300

The difference between the two entries for 10/15 is the account to be debited.

Example #5: Journalize the adjusting entry for accrued interest on December 31 for the following outstanding notes receivable. Journalize the receipt of the amount due on the due date for each note.

a) $24,000, 60-day, 10% note dated December 1.
b) $12,000, 90-day, 15% note dated October 22.

Solution #5:

a) Interest has been earned for 30 days
Days remaining in December 31 – December 1 = 30 days

Interest earned:
$24,000 x .10 x 30 days /360 days = $200

Interest receivable	200	
Interest revenue		200
Cash	24,400	
Notes receivable		24,000
Interest revenue *for January*		200
Interest receivable		200

b) Interest has been earned for 30 days
Days remaining in October 31 – October 22 = 9 days
Days in November = 30 days
Days in December = 31 days
Total days to accrue 70 days

Interest earned:
$12,000 x .15 x 70 days /360 days = $350

Interest receivable	350	
Interest revenue		350
Cash	12,450	
Notes receivable		12,000
Interest revenue *for Januar1*		100
Interest receivable		350

Practice Problem #2: Journalize the following transactions

a) 9/12 Received a $30,000, 12%, 120-day note on account.
b) 10/9 Received a $15,000, 10%, 60-day note on account.
c) 11/15 Received an $18,000, 15%, 30-day note on account.
d) 12/8 Received the amount due on the note of October 9.
e) 12/15 The note of November 15 was dishonored.
f) 12/31 Accrued interest on the note of September 12.

Practice Problem #3:

At the end of the year, two similar companies were in the process of calculating bad debt expense for the year. Each company had credit sales of $1,000,000 and a debit balance in Allowance for Uncollectible Accounts of $2,000 before any year-end adjustment. The balance of Accounts Receivable is $180,000.

Company A estimates that 5% of accounts receivable will not be collected over the next year Determine the following:

a) The uncollectible accounts expense for the year.
b) The adjusting entry to be made of December 31.
c) The balance in Allowance for Doubtful Accounts after adjustment.

Company B estimates that 5% of credit sales will not be collected over the next year Determine the following:

d) The uncollectible accounts expense for the year.
e) The adjusting entry to be made of December 31.
f) The balance in Allowance for Doubtful Accounts after adjustment.

Sample True / False Questions

1. The adjustment for uncollectible accounts involves a credit to Bad Debt Expense and a debit to the Allowance for Uncollectible Accounts.
   True False

2. The Allowance for Uncollectible Accounts is a contra asset account representing the amount of accounts receivable that the company does not expect to collect.
   True False

3. Bad debt expense is the amount of the adjustment to the allowance for uncollectible accounts that represents the cost of the estimated future bad debts.
   True False

4. One disadvantage of the allowance method (over the direct write-off method) for recording uncollectible accounts is that it generally matches bad debt expense with the revenue it helped to generate.
   True False

5. Under the allowance method, when a company writes off an account receivable as an actual bad debt, it reduces total assets.
   True False

6. Under the allowance method, when a company writes off an account receivable as an actual bad debt, it records an expense.
   True False

7. Under the allowance method, when a company collects cash from an account previously written off, total assets increase.
   True False

8. A credit balance in the Allowance for Uncollectible Accounts before adjustment indicates that last year's estimate of uncollectible accounts was too high.
   True False

9. A debit balance in the Allowance for Uncollectible Accounts before adjustment indicates that last year's estimate of uncollectible accounts was too low.
   True False

10. The direct write-off method violates the matching principle.
    True False

11. A company expects 5% of its newer accounts receivable to be uncollectible and 20% of its older accounts to be uncollectible. If the company has $40,000 of newer accounts and $5,000 of older accounts, the total estimate of uncollectible accounts is $2,000.
    True False

12. Notes receivable are similar to accounts receivable but are more formal credit arrangements evidenced by a written debt instrument, or note.
    True False

13. Notes receivable only arise from sales to customers.
    True False

14. Notes receivable typically earn interest revenue for the lender and interest expense for the borrower.
    True False

15. A $10,000 note that has a stated interest rate of 10% and is due in six months would have interest of $1,000.
    True False

16. Accrued interest on a note receivable is interest earned by the end of the year but not yet received.
    True False

17. The percentage-of-credit-sales method for estimating uncollectible accounts is commonly referred to as the income statement method, because it always results in a higher amount of net income being reported in the income statement.
    True False

18. Even though the percentage-of-receivables method and the percentage-of-credit-sales method use different accounts to estimate future uncollectible accounts, the amount of bad debt expense reported in the income statement will always be the same under the two methods.
    True False

19. From an income statement perspective, the percentage-of-credit-sales method is typically preferable because it better matches the revenues (credit sales) with their related expenses (bad debts).
    True False

20. From a balance sheet perspective, the percentage-of-receivables method is typically preferable because assets (net accounts receivable) are reported closer to their net realizable value.
    True   False

Sample Multiple Choice Questions

1. The internal control procedure most relevant to receivables is:
   a) Cost-benefit balance
   b) Safeguard assets
   c) Efficient operations
   d) Separate entity

2. A note receivable due in 5 years is listed on the balance sheet under the caption:
   a) Investments
   b) Current Assets
   c) Plant Assets
   d) Stockholders' Equity

3. The two methods of accounting for uncollectible receivables are the direct write-off method and the:
   a) Percentage of receivables method
   b) Aging of credit sales method
   c) Interest method
   d) Allowance method

4. The Allowance for Doubtful Accounts has a debit balance of $1,000 at the end of the year (before adjustment), and uncollectible accounts expense is estimated at 2% of net sales. If net sales are $600,000, the amount of the adjusting entry to record the provision for doubtful accounts is:
   a) $1,000
   b) $13,000
   c) $11,000
   d) $12,000

5. The Allowance for Doubtful Accounts has a debit balance of $1,000 at the end of the year (before adjustment), and uncollectible accounts estimate based on an aging schedule is $10,000. If accounts receivable are $600,000 the amount of the adjusting entry to record the provision for doubtful accounts is:
   a) $10,000
   b) $11,000
   c) $9,000
   d) $16,000

6. Allowance for Doubtful Accounts has a credit balance of $500 at the end of the year (before adjustment), and an analysis of customers' accounts indicates doubtful accounts of $11,500. Which of the following entries records the proper provision for doubtful accounts?
   a) Debit Uncollectible Accounts Expense, $11,000; credit Allowance for Doubtful Accounts, $11,000.
   b) Debit Uncollectible Accounts Expense, $12,000; credit Allowance for Doubtful Accounts, $12,000.
   c) Debit Allowance for Doubtful Accounts, $12,000; credit Uncollectible Accounts Expense, $12,000.
   d) Debit Allowance for Doubtful Accounts, $11,000; credit Uncollectible Accounts Expense, $11,000.

7. If the direct write-off method of accounting for uncollectible receivables is used, what general ledger account is debited to write off a customer's account as uncollectible?
   a) Uncollectible Accounts Payable
   b) Accounts Receivable
   c) Uncollectible Accounts Expense
   d) Allowance for Doubtful Accounts

8. The amount of the promissory note plus the interest earned on the due date is called the:
   a) Realizable value
   b) Face value
   c) Net realizable value
   d) Maturity value

9. A $7,000, 30-day, 12% note recorded on November 21 is not paid by the maker at maturity. The journal entry to recognize this event is:
   a) Debit Cash 7,070; Credit Notes Receivable 7,070
   b) Debit Accounts Receivable 7,070; Credit Notes Receivable 7,000; Credit Interest Revenue 70.
   c) Debit Notes Receivable 7,070; Credit Accounts Receivable 7,070
   d) Debit Accounts Receivable 7,070; Credit Notes Receivable 7,000; Credit Interest Receivable 70.

10. In reference to a promissory note, another word(s) for "discount" is:
   a) Fair Value
   b) Interest
   c) To buy for more than face value
   d) Maturity

11. Receivables are usually listed on the Balance Sheet after cash in what order?
    a) Cash, Accounts Receivable, Notes Receivable, Interest Receivable
    b) Cash, Interest Receivable, Notes Receivable, Accounts Receivable
    c) Cash, Notes Receivable, Accounts Receivable, Interest Receivable
    d) Cash, Notes Receivable, Interest Receivable, Accounts Receivable

12. Receivables are usually listed in order
    a) Of liquidity
    b) Of the due date
    c) Of the size
    d) Alphabetically

13. Accounts Receivable Turnover measures
    a) Number of days outstanding
    b) Fair market value of Accounts Receivables
    c) The efficiency of the accounts payable function
    d) How frequently during the year the Accounts Receivable are converted to cash

14. The Number of Days Sales in Receivables
    a) Measures the number of times the receivables turn over each year
    b) Is Net Credit Sales divided by Average Receivables
    c) Is not meaningful and therefore not used
    d) Is an estimate of the length of time the receivables have been outstanding

15. Accounts receivable are reported on the balance sheet at their
    a) Fair market value
    b) Present value
    c) Net realizable value
    d) Maturity value

16. When an account is written off under the allowance method the
    a) Uncollectible Accounts Expense account is debited.
    b) Accounts Receivable account is debited.
    c) Allowance for Doubtful Accounts is debited.
    d) Loss on Accounts Receivable account is debited.

17. A note receivable is recorded at its
    a) Face Value
    b) Fair market value
    c) Present value
    d) Maturity value

18. A 90-day note dated April 13 has a maturity date of

a) July 10
b) July 11
c) July 12
d) July 13

19. The interest on a $6,000, 8%, 240-day note receivable is
    a) $320
    b) $480
    c) $32
    d) $48

20. Winter Company receives a $3,000, 120-day, 10% note from Futon Company as a payment of its account receivable. What entry will Winter Company make when it receives the note?
    a) Debit Notes Receivable, 3,100; Credit Accounts Receivable 3,100
    b) Debit Notes Receivable, 3,100; Credit Accounts Receivable 3,000
    c) Debit Notes Receivable, 3,000 and Interest Receivable, 100; Credit Accounts Receivable, 3,000 and Interest Revenue, 100
    d) Debit Notes Receivable, 3,000; Credit Accounts Receivable, 3,000

21. Craft Co. loaned $24,000 to Sims Co. on December 1,at 10% interest for 90 days. What adjusting entry will Craft Co. have to make on December 31 before preparing the financial statements.
    a) Debit Interest Receivable, 600; Credit Interest Revenue, 600
    b) Debit Interest Receivable, 200; Credit Interest Revenue, 200
    c) Debit Interest Receivable, 1,000; Credit Interest Revenue, 1,000
    d) Debit Interest Receivable, 2,400; Credit Interest Revenue, 2,400

Solutions to Practice Problems

Practice Problem #1

05/14	Cash	15,000	
	Allowance for Doubtful Accts	5,000	
	Accounts Receivable-Webb		20,000
06/20	Accounts Receivable	5,225	
	Allowance for Doubtful Accts		5,225
	Cash	5,225	
	Accounts Receivable		5,225
07/27	Allowance for Doubtful Accts	2,500	
	Accounts Receivable		2,500
12/31	Uncollectible Accounts Expense	11,300	
	Allowance for Doubtful Accts		11,300
	11,500 – 200 credit balance= 11,300		

a) 11,500 *(based on analysis of A/R)*

b)

Accounts receivable	$62,000
Less: Allowance for doubtful accounts	11,500
Net Realizable Value	$50,500

12/31	Uncollectible Accounts Expense	10,000	
	Allowance for Doubtful Accts		10,000
	2,000,000 x .01 x .5 = 10,000		

a) 10,200 = 10,000 + 200 credit balance

b)

Accounts receivable	$62,000
Less: Allowance for doubtful accounts	10,200
Net Realizable Value	$51,800

Practice Problem #2

a)	09/12	Notes Receivable	30,000	
		Accounts Receivable		30,000
b)	10/09	Notes Receivable	15,000	
		Accounts Receivable		15,000
c)	11/15	Notes Receivable	18,000	
		Accounts Receivable		18,000
d)	12/08	Cash	15,250	
		Notes Receivable		15,000
		Interest Revenue		250
		*(15,000 * .10 * 60/360 = $250 interest)*		
e)	12/15	Accounts Receivable	18,225	
		Notes Receivable		18,000
		Interest Revenue		225
		*(18,000 * .15 * 30/360 = $225 interest)*		
f)	12/31	Interest Receivable	1,100	
		Interest Revenue		1,100
		Sept 12 – Dec 31 = 110 days		
		*30,000 * .12 * 110/360 = $1,100 interest*		

Practice Problem #3

a) Allowance for Doubtful Accounts

Balance 2,000	
	Uncollectible accounts expense = ?
Accounts receivable written-off =8,000	
	9,000 ending balance

Uncollectible accounts expense = 9,000 + 8,000 + 2,000 = 19,000

b) Uncollectible accounts expense 19,000
Allowance for doubtful accounts 19,000

c) 9,000

d) Allowance for Doubtful Accounts

Balance 2,000	
	Uncollectible accounts expense = 50,000 *1,000,000 x .05*
Accounts receivable written-off =8,000	
	40,000 ending balance

Allowance of Doubtful Accounts balance = -2,000 + 50,000 – 8,000 = 40,000

e) Uncollectible accounts expense 50,000
Allowance for doubtful accounts 50,000

f) 40,000

Solutions to true / false Questions

1. False – the entry typically debits bad debt expense and credits the allowance for uncollectible accounts
2. True
3. True
4. False - this is generally an advantage of the allowance method.
5. False – writing off an account receivable has no effect on total assets.
6. False - writing off an account receivable has no effect on expenses.
7. False - collecting cash from an account previously written off has no effect on total assets.
8. False – a credit balance in the allowance account indicates the amount of accounts receivable considered uncollectible.
9. True
10. True
11. False - estimated uncollectible accounts = (\$40,000 × 5%) + (\$5,000 × 20%) = \$3,000.
12. True
13. False - notes receivable typically arise from loans to other entities including affiliated companies, loans to stockholders and employees as well as from the sale of merchandise or services.
14. True
15. False - interest = principle (\$10,000) × annual interest rate (10%) × fraction of year (6/12) = \$500.
16. True
17. False - this method is referred to as the income statement method because the estimate of bad debts is based on an income statement amount—credit sales.
18. False - bad debt expense will typically differ between the two methods.
19. True
20. True

Solutions to Multiple Choice Questions

1.	B
2.	A
3.	D
4.	D
5.	B
6.	A
7.	C
8.	D
9.	B
10.	B
11.	C
12.	A
13.	D
14.	D
15.	C
16.	C
17.	A
18.	C
19.	A
20.	D
21.	B