Introduction to Accounting 2

Modul 2

Accounting for Receivables

After studying this chapter, you should be able to:

1. Identify the different types of receivables.
2. Explain how accounts receivable are recognized in the accounts.
3. Distinguish between the methods and bases used to value accounts receivable.
4. Describe the entries to record the disposition of accounts receivable.
5. Compute the maturity date of and interest on notes receivable.
6. Explain how notes receivable are recognized in the accounts.
7. Describe how notes receivable are valued.
8. Describe the entries to record the disposition of notes receivable.
9. Explain the statement presentation and analysis of receivables.

RECEIVABLES (Study Objective 1)

- Amounts due from individuals and other companies
    - claims expected to be collected in cash,
- Three major classes of receivables are
    1. Accounts Receivable
    - amounts owed by customers on account
    - ***Accounts receivable*** are normally expected to be collected within a relatively short period, such as 30 or 60 days.

    2. Notes Receivable
    - claims for which formal instruments of credit are issued

    3. Other Receivables
    - non-trade receivables . Examples: interest receivable and advances to employees
    - ***Other receivables*** expected to be collected within one year are classified as current assets. If collection is expected beyond one year, these receivables are classified as noncurrent assets and reported under the caption ***Investments***.

ACCOUNTS RECEIVABLE

Three primary accounting issues with accounts receivable:

1. Recognizing accounts receivable.
2. Valuing accounts receivable.

3. Disposing of accounts receivable.

RECOGNIZING ACCOUNTS RECEIVABLE (Study Objective 2)

General Journal			
Date	Account Titles	Debit	Credit
July 1	Accounts Receivable – Polo Co.	1,000	
	Sales		1,000

When a business sells merchandise to a customer on credit, Accounts Receivable is debited and Sales is credited. Assume credit terms are 2/10, n/30.

General Journal			
Date	Account Titles	Debit	Credit
July 5	Sales Returns and Allowances	100	
	Accounts Receivable – Polo Company		100

When a business receives returned merchandise previously sold to a customer on credit, Sales Returns and Allowances is debited and Accounts Receivable is credited.

Cash ($900-$18)	882	
Sales Discounts ($900 x .02)	18	
Accounts Receivable – Polo Company		900
(To record collection of AR)		

When a business collects cash from a customer for merchandise previously sold on credit during the discount period, Cash and Sales Discounts are debited and Accounts Receivable is credited.

VALUING ACCOUNTS RECEIVABLE (Study Objective 3)

- Cash (net) realizable value
  - net amount expected to be received in cash and excludes amounts that the company estimates it will not be able to collect
- Credit losses
  - debited to Bad Debts Expense
  - considered a normal and necessary risk of doing business.
- Two methods of accounting for uncollectible accounts are:
  1. Direct write-off method

2. Allowance method

DIRECT WRITE-OFF METHOD

- Direct write-off method
  - Bad debt losses are not anticipated and no allowance account is used
  - No entries are made for bad debts until an account is determined to be uncollectible at which time the loss is charged to Bad Debts Expense
- No matching
- No cash realizable value of accounts receivable on the balance sheet
- Not acceptable for financial reporting purposes

General Journal			
Date	Account Titles	Debit	Credit
Dec. 12	**Bad Debts Expense**	**200**	
	Accounts Receivable – M.E. Doran		**200**

Warden Co. writes off M. E. Doran's $200 balance as uncollectible on December 12. When this method is used, Bad Debts Expense will show only actual losses from uncollectibles.

THE ALLOWANCE METHOD

- Allowance method
  - required when bad debts are deemed to be material in amount.
- Uncollectible accounts are estimated
  - expense for the uncollectible accounts is matched against sales in the same accounting period in which the sales occurred.

General Journal			
Date	Account Titles	Debit	Credit
Dec. 31	**Bad Debts Expense**	**12,000**	
	Allowance for Doubtful Accounts		**12,000**

Estimated uncollectible are debited to Bad Debts Expense and credited to Allowance for Doubtful Accounts at the end of each period.

General Journal			
Date	Account Titles	Debit	Credit
Mar. 1	**Allowance for Doubtful Accounts**	**500**	
	Accounts Receivable - R. A. Ware		**500**

Actual uncollectible are debited to Allowance for Doubtful Accounts and credited to Accounts Receivable at the time the specific account is written off.

General Journal			
Date	Account Titles	Debit	Credit
July 1	**Accounts Receivable – R. A. Ware**	**500**	
	Allowance for Doubtful Accounts		**500**

When there is recovery of an account that has been written off: 1). reverse the entry made to write off the account and 2). record the collection in the usual manner

General Journal			
Date	Account Titles	Debit	Credit
July 1	**Cash**	**500**	
	Accounts Receivable		**500**

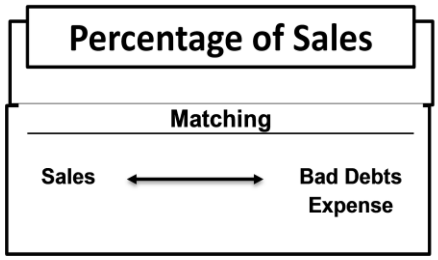
BASES USED FOR THE ALLOWANCE METHOD

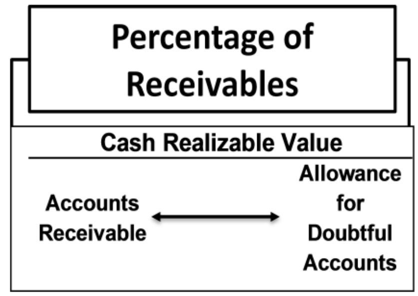
- Companies use one of two methods in the estimation of uncollectible:
  1. Percentage of sales
  2. Percentage of receivables
- Both bases are GAAP; the choice is a management decision.

COMPARING THE DIRECT WRITE-OFF AND ALLOWANCE METHODS

	Direct Write-Off Method	**Allowance Method**
Amount of bad debt expense recorded	When the actual accounts receivable are determined to be uncollectible	Using estimate based on either (1) a percentage of sales or (2) analysis of receivables.
Allowance account	No allowance account is used	The allowance account is used
Primary users	Small companies and companies with relatively few receivables	Large companies and those with a large amount of receivables

COMPARISON OF BASES OF ESTIMATING UNCOLLECTIBLES





Emphasis on Income Statement Relationships Emphasis on Balance Sheet Relationships

PERCENTAGE OF SALES BASIS

- Management estimates what percentage of credit sales will be uncollectible.
- Expected bad debt losses are determined by applying the percentage to the sales base of the current period.
- Better match
    - Expenses with revenues

General Journal			
Date	Account Titles	Debit	Credit
Dec. 31	**Bad Debts Expense**	**8,000**	
	Allowance for Doubtful Accounts		**8,000**

If net credit sales for the year are $800,000, the estimated bad debts expense is $8,000 (1% X $800,000).

PERCENTAGE OF RECEIVABLES BASIS

- Management estimates what percentage of receivables will result in losses from uncollectible accounts.
- Amount of the adjusting entry
    - difference between the required balance and the existing balance in the allowance account
- Produces the better estimate of cash realizable value of receivables.

PERCENTAGE OF RECEIVABLES BASIS

General Journal			
Date	Account Titles	Debit	Credit
Dec. 31	**Bad Debts Expense**	**1,700**	
	Allowance for Doubtful Accounts		**1,700**

If the trial balance shows Allowance for Doubtful Accounts with a credit balance of $528, and the required ending balance in the account is $2,228, an adjusting entry for $1,700 ($2,228 - $528) is necessary.

DISPOSING OF ACCOUNTS RECEIVABLE (Study Objective 4)

- Companies frequently dispose of accounts receivable in one of two ways:
  1. Sell to a factor such as a finance company or a bank
     Factor buys receivables from businesses for a fee and collects the payment directly from customers
  2. Make credit card sales

SALE OF RECEIVABLES

General Journal			
Date	Account Titles	Debit	Credit
	Cash	**588,000**	
	Service Charge Expense (2% x $600,000)	**12,000**	
	Accounts Receivable		**600,000**

Hendrendon Furniture factors $600,000 of receivables to Federal Factors, Inc. Federal Factors assesses a service charge of 2% of the amount of receivables sold.

CREDIT CARD SALES

- Credit cards
  - used by retailers who wish to avoid the paperwork of issuing credit
  - cash is received quickly from the credit card issuer

- National credit cards
  - Visa, MasterCard, Discover, and American Express
- Three parties
  1. credit card issuer
  2. retailer
  3. customer
- Retailer pays the credit card issuer a fee of 2-6% of the invoice price for its services.
- From an accounting standpoint, sales from Visa, MasterCard, and Discover are treated differently than sales from American Express.

VISA, MASTERCARD, AND DISCOVER SALES

- Visa, mastercard, and discover

- Cards issued by banks
- Considered cash sales by the retailer

- Upon receipt of credit card sales slips from a retailer
    - The bank immediately adds the amount to the seller’s bank balance

General Journal			
Date	Account Titles	Debit	Credit
	Cash	**970**	
	Service Charge Expense	**30**	
	Sales		**1,000**

Anita Ferreri purchases a number of compact discs for her restaurant from Karen Kerr Music Co. for $1,000 using her VISA First Bank Card. The service fee that First Bank charges is 3%.

AMERICAN EXPRESS SALES

- American express cards
    - Reported as credit sales, not cash sales
- Conversion to cash does not occur until the american express remits the net amount to the seller.

General Journal			
Date	Account Titles	Debit	Credit
	Accounts Receivable – American Express	**285**	
	Service Charge Expense	**15**	
	Sales		**300**

Four Seasons Restaurant accepts an American Express card for a $300 bill. The service fee that American Express charges is 5%.

NOTES RECEIVABLE

- Promissory note: Written promise to pay a specified amount of money on demand or at a definite time.
- Maker: The party making the promise.
- Payee: The party to whom payment is made.
- Life of the note expressed in terms of months: The due date is found by counting the months from the date of issue
  Example: The maturity date of a 3-month note dated May 31 is August 31.

DETERMINING THE MATURITY DATE (Study Objective 5)

- Life of the note is expressed in terms of days
    - you need to count the days.

- The date of issue is omitted but the due date is included.

- Example: The maturity date of a 60-day note dated July 17 is:

Term of note		60
July 31 – 17	14	
August	31	45
Maturity date: September		15

FORMULA FOR COMPUTING INTEREST

The basic formula for computing interest on an interest-bearing note is:

$$\boxed{\text{Face Value of Note}} \times \boxed{\text{Annual Interest Rate}} \times \boxed{\text{Time in Terms of One Year}} = \boxed{\text{Interest}}$$

The interest rate specified on the note is an annual rate of interest.

COMPUTATION OF INTEREST

Terms of Note	Interest Computation						
	Face	X	Rate	X	Time	=	Interest
$ 730, 18%, 120 days	$ 730	X	18%	X	120/360	=	$ 43.80
$1,000, 15%, 6 months	$1,000	X	15%	X	6/12	=	$ 75.00
$2,000, 12%, 1 year	$2,000	X	12%	X	1/1	=	$240.00

Helpful hint: The interest rate specified is the annual rate.

RECOGNIZING NOTES RECEIVABLE (Study Objective 6)

General Journal			
Date	Account Titles	Debit	Credit
May 1	Notes Receivable	1,000	
	Accounts Receivable – Brent Company		1,000

Wilma Company receives a $1,000, 2-month, 12% promissory note from Brent Company to settle an open account.

VALUING NOTES RECEIVABLE (Study Objective 7)

- Like accounts receivable, short-term notes receivable are reported at their cash (net) realizable value.

- The notes receivable allowance account is Allowance for Doubtful Accounts

HONOR OF NOTES RECEIVABLE (Study Objective 8)

Nov. 1	Cash	10,375	
	Notes Receivable		10,000
	Interest Revenue		375
	(To record collection of Higley Inc. note)		

- A note is honored when it is paid in full at its maturity date.
- For an interest-bearing note, the amount due at maturity is the face value of the note plus interest for the length of time specified on the note.
- Betty Co. lends Wayne Higley Inc. $10,000 on June 1, accepting a 5-month, 9% interest-bearing note.
- Betty Co. collects the maturity value of the note from Wayne Higley Inc. on November 1.

HONOR OF NOTES RECEIVABLE

Sept. 30	Interest Receivable	300	
	Interest Revenue		300
	(To accrue 4 months' interest)		

If Betty Co. prepares prepares financial statements as of September 30, interest for 4 months, or $300, would be accrued.

Nov. 1	Cash	10,375	
	Notes Receivable		10,000
	Interest Receivable		300
	Interest Revenue		75

When interest has been accrued, it is necessary to credit Interest Receivable at maturity.

DISHONOR OF NOTES RECEIVABLE

General Journal			
Date	Account Titles	Debit	Credit
Nov. 1	Accounts Receivable	10,375	
	Notes Receivable		10,000
	Interest Revenue		375

- A dishonored note is a note that is not paid in full at maturity.
- A dishonored note receivable is no longer negotiable.

- Since the payee still has a claim against the maker of the note, the balance in Notes Receivable is usually transferred to Accounts Receivable.

BALANCE SHEET PRESENTATION OF RECEIVABLES (STUDY OBJECTIVE 9)

- In the balance sheet, short-term receivables are reported in the current assets section below short-term investments.
- Report both the *gross amount of receivables* and the *allowance for doubtful accounts.*

ACCOUNTS RECEIVABLE TURNOVER RATIO AND COMPUTATION

- Ratios are computed to evaluate the liquidity of a company's accounts receivable.
- Accounts receivables turnover ratio used to assess the liquidity of the receivables.
- If Cisco had net credit sales of $18, 915 million for the year and beginning net accounts receivable balance of $1,466 million and ending net accounts receivable balance of $1,105 million, then:

$$\boxed{\text{Net Credit Sales}} \;/\; \boxed{\text{Average Net Receivables}} \;=\; \boxed{\text{Accounts Receivable Turnover}}$$

$18,915 / ($1,466 + $1,105)/2 = 14.7 times

AVERAGE COLLECTION PERIOD FOR RECEIVABLES FORMULA AND COMPUTATION

- Variant of the turnover ratio that makes liquidity even more evident.
- This is done by dividing the turnover ratio into 365 days. The *general rule* is that the collection period should not exceed the credit term period.
- Cisco's turnover ratio is computed as:
  Days in Year/AR Turnover = Average Collection Period in Days
  365 days / 14.7 times = 24.8 days

REVIEW

1. Which of the following statements about VISA credit card sales is incorrect?
a. The credit card issuer makes the credit investigation of the customer.
b. The retailer is not involved in the collection process.
c. Two parties are involved.

2. Which of the following approaches for bad debts is best described as a balance sheet method?
a. Percentage of receivables basis.
b. Direct write-off method.
c. Percentage of sales basis.
d. Both a and b.

3. PT Delta is a construction supply company, uses the allowance method of accounting for uncollectible. Selected transactions completed by PT Deltaare as follows:

Feb 1	Sold merchandise on account to PT Anya Rp8.000.000,00. The cost of merchandise sold was Rp4.500.000,00.
Mar 15	Accepted a 60-day, 12% note for Rp8.000.000 from PT Anya on account.
Apr 9	Wrote-off a Rp2.500.000,00 account from PT Dorres as uncollectible.
Apr 21	Loaned Rp7.500.000,00 from Jamilah., receiving a 90-day , 14% note
May 14	Received the interest due from PT Anya and a new 90-day, 14% note as a renewal of the loan. (Record both the debit and credit to the notes receivable account)
June 13	Reinstated the account of PT Dorres, Written off on 9th April, and received Rp2.500.000,00 in full payment.
July 20	Jamilah dishonor her note.
Aug. 12	Received from PT Anya the amount due on its note of May 14.
Aug.19	Received from Jamilah the amount owed on the dishonored note, plus interestfor 30 days at 15%, computed on the maturity value of the note.
Dec.16	Accepted a 60-day, 12% note for Rp12.000.000,00 from PT Guntur on account.
Dec. 31	It is estimated that 3% of the credit sales of Rp1.375.000.000,00 for the year ended December 31 will be uncollectible

Instruction:
1. Journalized the transactions
2. Journalized the adjusting entries to record the accrued interest on Dec 31 on the PT Guntur note.

References

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Reeve, James M, Caarl S. Waren and Jonathan E. Duchac. Principles of Accounting. Singapore: Cengage Learning Asia Pte Ltd. (R)