Chapter 7 - Accounts Receivable

P1

Matching vs. Materiality

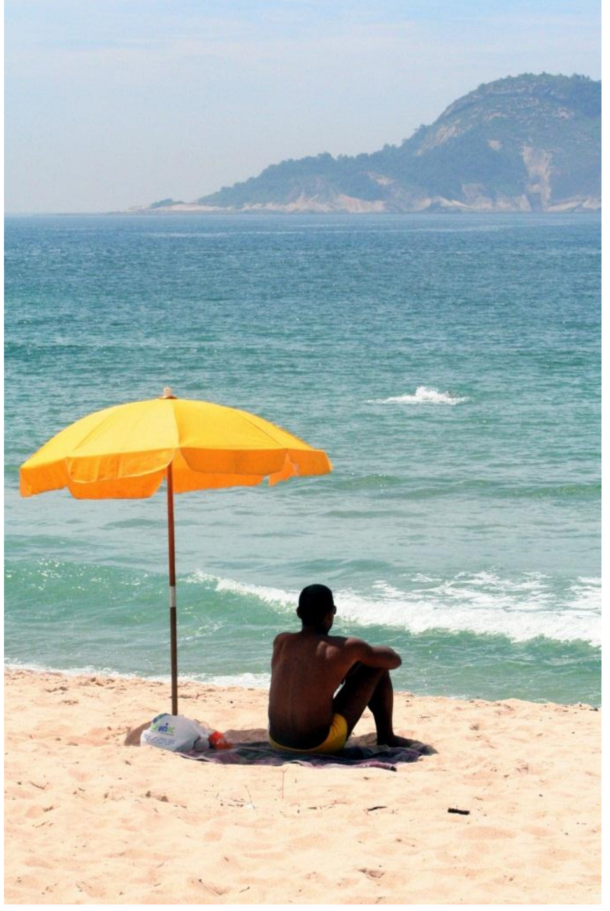
The Matching Principle requires expenses to be reported in the same accounting period as the sales they help produce.

The Materiality Constraint Principle states that an amount can be ignored if its effect on the financial statements is unimportant to users' business decisions.

Materiality Constraint

An amount can be ignored if its effect on the financial statements isn't enough to matter.

For example, a millionaire went to the bank and withdrew $10,000 from the bank. After a weekend at the beach, he can't figure out where $10 of his money went. Does he go back and re-trace his steps to figure it out?



C 1

Sales on Credit

On July 16, Barton, Co. sells $950 of merchandise on credit to Webster, Co., and $1,000 of merchandise on account to Matrix, Inc.

Jul. 16	**Accounts Receivable - Webster**	**950**	
	Sales		**950**
	To record credit sales to Webster Co.		
	Accounts Receivable - Matrix	**1,000**	
	Sales		**1,000**
	To record credit sales to Matrix, Inc.		

C 1

Sales on Credit

Accounts Receivable Ledger

Webster, Co.

Date	PR	Debit	Credit	Balance
Jul. 16		950		950

Matrix, Inc.

Date	PR	Debit	Credit	Balance
Jul. 16		1,000		1,000

Schedule of Accounts Receivable

Webster, Co.	$ 950
Matrix, Inc.	1,000
Total	$1,950

General Ledger

Accounts Receivable

Date	PR	Debit	Credit	Balance
Jul. 16		1,950		1,950

C 1

Sales on Credit

On July 31, Barton, Co. collects $500 from Webster, Co., and $800 from Matrix, Inc. on account.

Jul. 31	**Cash**	**500**	
	Accounts Receivable - Webster		**500**
	To record cash collections on account		
	Cash	**800**	
	Accounts Receivable - Matrix		**800**
	To record cash collections on account		

C 1

Sales on Credit

Accounts Receivable Ledger

Webster, Co.				
Date	PR	Debit	Credit	Balance
Jul. 16		950		950
Jul. 31			500	450

Matrix, Inc.				
Date	PR	Debit	Credit	Balance
Jul. 16		1,000		1,000
Jul. 31			800	200

Schedule of Accounts Receivable

Webster, Co.	$ 450
Matrix, Inc.	200
Total	$ 650

General Ledger

Accounts Receivable				
Date	PR	Debit	Credit	Balance
Jul. 16		1,950		1,950
Jul. 31			1,300	650

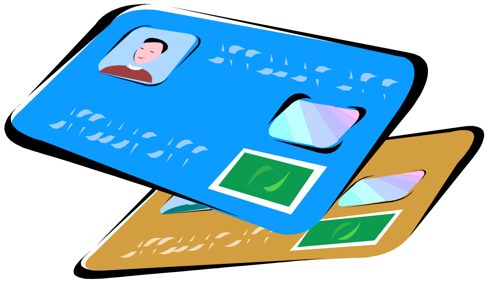
C 1

Credit Card Sales

Advantages of allowing customers to use credit cards:

Customers' credit is evaluated by the credit card issuer.

Sales increase by providing purchase options to the customer.



The risks of extending credit are transferred to the credit card issuer.

Cash collections are quicker.

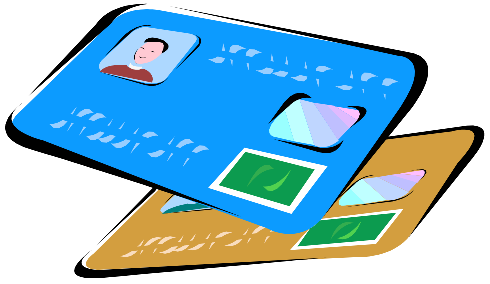
C 1

Credit Card Sales

❶ With bank credit cards, the seller deposits the credit card sales receipt in the bank just like it deposits a customer’s check.

❷ The bank increases the balance in the company’s checking account.

❸ The company usually pays a fee of 1% to 5% for the service.



C 1

Credit Card Sales

On July 16, 2012, Barton, Co. has a bank credit card sale of $500 to a customer. The bank charges a processing fee of 2%. The cash is received immediately.

Jul. 16	Cash	490	
	Credit Card Expense	10	
	Sales		500
	To record credit card sales and fees		

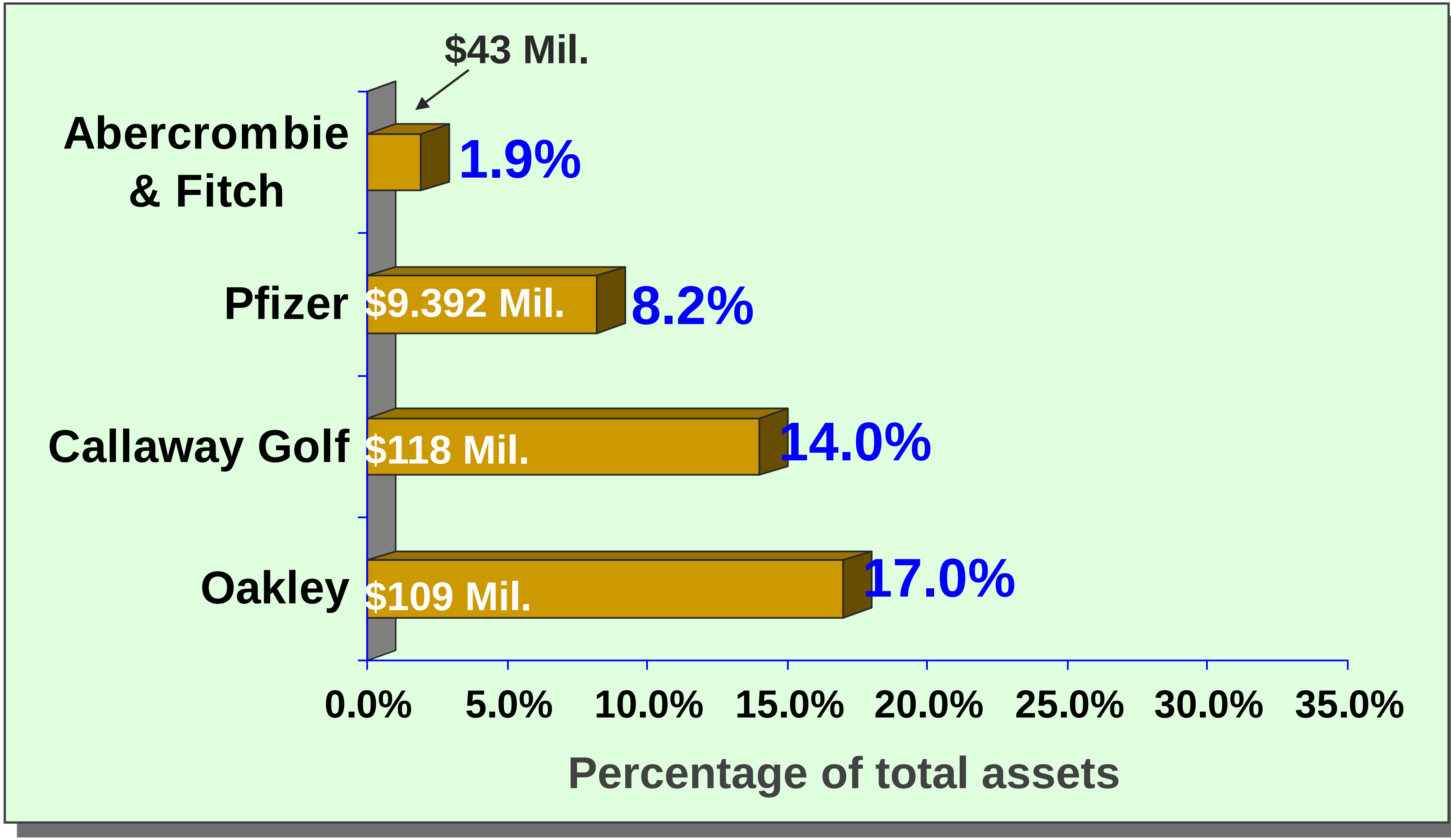
C 1

Accounts Receivable

- Amounts due from customers for credit sales.
- Credit sales require:
  - Maintaining a separate account receivable for each customer.
  - Accounting for bad debts from customers we do not expect to pay.

C 1

Recognizing Accounts Receivable

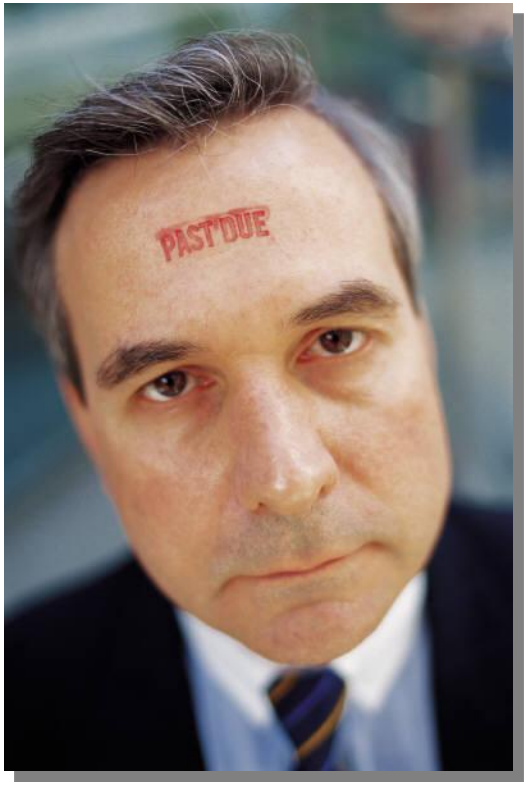


P1

Valuing Accounts Receivable

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 -** ***doesn't follow GAAP because it violates the matching principle.***
- **Allowance Method**



The Quality of Receivables

- The quality of receivables measures the likelihood that all amounts due from a customer will be collected in full, without any losses.

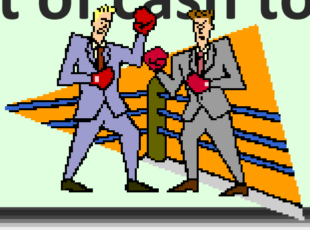
P1

Allowance Method

At the end of each period, estimate total bad debts expected to be realized from that period's sales.

There are two advantages to the allowance method:

1. It records estimated bad debts expense in the period when the related sales are recorded. ***Follows GAAP (matching principle)***
2. It reports accounts receivable on the balance sheet at the estimated amount of cash to be collected.



P1

Recording Bad Debts Expense

At the end of its first year of operations, Barton Co. estimates that $3,000 of its accounts receivable will prove uncollectible. The total accounts receivable balance at December 31, 2012, is $278,000.

		DR	CR
Dec. 31	Bad Debts Expense	3,000	
	Allowance for Doubtful Accounts		3,000
	To record estimated bad debts		

Contra-asset account

Accounts Receivable

Bal.	278,000		

Allowance for Doubtful Accounts

		Dec. 31	3,000

P1

Recording Bad Debts Expense

At the end of its first year of operations, Barton Co. estimates that $3,000 of its accounts receivable will prove uncollectible. The total accounts receivable balance at December 31, 2012, is $278,000.

Barton, Co.
Partial Balance Sheet
December 31, 2012

Cash		
Accounts receivable	**$ 278,000**	
Less: Allowance for doubtful accounts	**3,000**	**$ 275,000**

P2

Estimating Bad Debts Expense

A. **Percent of Sales Method –**
   - A. **Income Statement Driven**
   - B. **Calculating the Journal Entry**

B. **Accounts Receivable Methods**
   1) **Percent of Accounts Receivable Method**
   2) **Aging of Accounts Receivable Method**
   - ❖ **Calculations for BOTH A/R methods (1&2 above):**
     - a) **Balance Sheet Driven**
     - b) **Calculating the Ending Balance to Allowance for Doubtful Accts.**

P2

Percent of Sales Method

Bad debts expense is computed as follows:

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

Barton has credit sales of $1,400,000 in 2012. Management estimates 0.5% of credit sales will eventually prove uncollectible.

What is Bad Debts Expense for 2012?

P2

Percent of Sales Method

	$	1,400,000
×		0.50%
=	$	7,000

Barton's accountant computes estimated Bad Debts Expense of $7,000.

		DR	CR
Dec. 31	Bad Debts Expense	7,000	
	Allowance for Doubtful Accounts		7,000
	To record estimated bad debts		

Exercise 7-4 – Dec 31 entry only

P2

Percent of Accounts Receivable Method

1. **Compute the estimate of the Allowance for Doubtful Accounts.**

   Year-end Accounts Receivable × Bad Debt %

2. **Bad Debts Expense is computed as:**

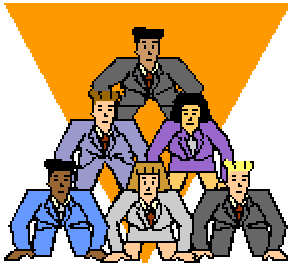
	Estimated Adj. Bal. in Allowance for Doubtful Accounts
-	**Unadj. Year-End Bal. in Allowance for Doubtful Accounts**
=	**Estimated Bad Debts Expense**

P2

Percent of Accounts Receivable

Barton has $100,000 in accounts receivable and a $900 credit balance in Allowance for Doubtful Accounts on December 31, 2012. Past experience suggests that 4% of receivables are uncollectible.

What is Barton's Bad Debts Expense for 2012?



P2

Percent of Accounts Receivable

Desired balance in Allowance for Doubtful Accounts.

	$	100,000
×		4.00%
=	$	4,000

Allowance for Doubtful Accounts

	900
	3,100
	4,000

		DR	CR
Dec. 31	Bad Debts Expense	3,100	
	Allowance for Doubtful Accounts		3,100
	To record estimated bad debts		

Go over Ex 7-5

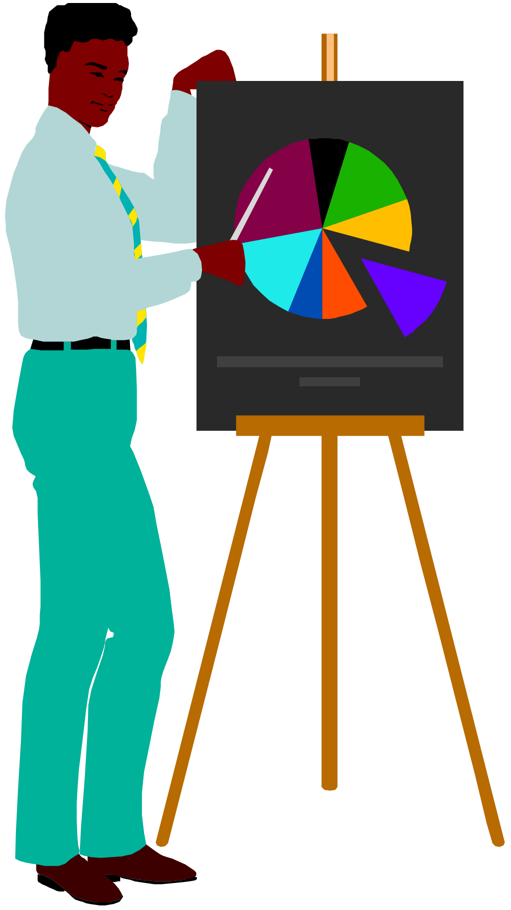
P2

Aging of Accounts Receivable Method

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

- Each age group is multiplied by its estimated bad debts percentage.

- Estimated bad debts for each group are totaled.



P2

Aging of Accounts Receivable

Barton, Co. Schedule of Accounts Receivable by Age December 31, 2012			
Days Past Due	Accounts Receivable Balance	Percent Uncollectible	Estimated Uncollectible Amount
Not Yet Due	$ 64,500	1%	$ 645
1 - 30 Days Past Due	18,500	3%	555
31 - 60 Days Past Due	10,000	7%	700
61 - 90 Days Past Due	3,900	40%	1,560
Over 90 Days Past Due	3,100	60%	1,860
	$ 100,000		$ 5,320

P2

Aging of Accounts Receivable

Barton's unadjusted balance in the allowance account is $900.

We estimated the proper balance to be $5,320.

Allowance for Doubtful Accounts	
	900
	4,420
	5,320

		DR	CR
Dec. 31	Bad Debts Expense	4,420	
	Allowance for Doubtful Accounts		4,420
	To record estimated bad debts		

Go over Ex 7-6

P2

Writing Off a Bad Debt

With the allowance method, when an account is determined to be uncollectible, the debit goes to Allowance for Doubtful Accounts (a contra asset account).

Barton determines that Martin's $300 account is uncollectible.

		DR	CR
Dec. 31	Allowance for Doubtful Accounts	300	
	Accounts Receivable - Martin		300
	To write-off an uncollectible account		

P2

Recovery of a Bad Debt

Subsequent collections on accounts written off require that the original write-off entry be reversed before the cash collection is recorded.

		DR	CR
Feb. 8	Accounts Receivable - Martin	300	
	Allowance for Doubtful Accounts		300
	To reinstate account previously written off		
Feb. 8	Cash	300	
	Accounts Receivable - Martin		300
	To record full payment on account		

Go over Ex 7-4 (Feb 1 & June 5 entry)

P2

Summary

% of Sales	% of Receivables	Aging of Receivables
Emphasis on Matching	Emphasis on Realizable Value	Emphasis on Realizable Value
Sales / Bad Debts Exp.	Accts. Rec. / All. for Doubtful Accts.	Accts. Rec. / All. for Doubtful Accts.
Income Statement Focus	Balance Sheet Focus	Balance Sheet Focus

Notes Receivable

Notes Receivables are a promise to pay a specific amount of money, usually with interest.

Notes Receivable are sued to pay for products and services, or lending and borrowing money.

Sellers will sometimes ask for a notes receivable instead of an accounts receivable when a customer needs additional time to pay their bill and the amount due is large.

P3

Notes Receivable

P3

Interest Computation

Principal of the note × Annual interest rate × Time expressed in years = Interest

Even for maturities less than one year, the rate is annualized.

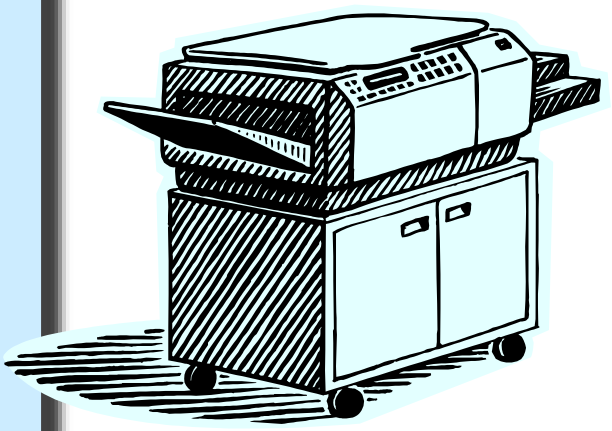
If the note is expressed in days, base a year on 360 days.

P3

Computing Maturity and Interest

On March 1, 2012 Matrix, Inc. purchased a copier for $12,000 from Office Supplies, Inc. Matrix gave Office Supplies a 9% note due in 90 days in payment for the copier.

What is the maturity date of the note (the date payment is due)?



P3

Computing Maturity and Interest

Days in March	31	
Minus the date of the note	1	
Days remaining in March		30
Days in April		30
Days in May to maturity		30
Period of the note in days		90

The note is due and payable on May 30, 2012.

How much interest will Matrix pay to Office Supplies, Inc. on this note?

P3

Computing Maturity and Interest

Principal of the note	×	Annual interest rate	×	Time expressed in years	=	Interest
$ 12,000	×	9%	×	90/360	=	$ 270

Total interest due at May 30.

P3

Recognizing Notes Receivable

Here are the entries to record the note on March 1, and the settlement on May 30, 2012.

		DR	CR
Mar. 1	Notes Receivable	12,000	
	Sales		12,000
	Sold goods in exchange for note		

		DR	CR
May 30	Cash	12,270	
	Interest Revenue		270
	Notes Receivable		12,000
	Collected note and interest due		

P4

Recording End-of-Period Interest Adjustments

On December 1, 2012, Matrix, Inc. purchased a copier for $12,000 from Office Supplies, Inc. Matrix issued a 9% note due in 90 days in payment for the copier. What adjusting entry is required on December 31, the end of the company's accounting period?

$12,000 × 9% × 30/360 = $90

		DR	CR
Dec. 31	Interest Receivable	90	
	Interest Revenue		90
	To accrue interest on note		

P4

Recording End-of-Period Interest Adjustments

Recording collection on note at maturity.

Days in December	31	
Minus the date of the note	(1)	
Day remaining in December		30
Days in January		31
Days in February		28
Days in March until maturity		1
Period of the note in days		90

		DR	CR
Mar. 1	Cash	12,270	
	Interest Receivable		90
	Interest Revenue		180
	Notes Receivable		12,000
	To record full payment of note		

Go over Ex 7-11

Disposing of Receivables

- Companies sometimes want to convert receivables to cash before they are due.
- They can sell or factor receivables.
- They may pledge receivables as security for a loan.

A1

Accounts Receivable Turnover

This ratio indicates how often accounts receivable are received and collected during an accounting period.

$$\frac{\textbf{Net sales}}{\textbf{Average accounts receivable}}$$