

Accounts Receivable

- receivables refers to the amounts due to a business from its customers or other entities
- are claims that are expected to be collected in cash
- classified as
 - accounts receivable
 - notes receivable
 - other receivables
- **financial assets** are receivables along with certain investments
 - represents a contractual right to receive cash or another financial asset
- **accounts receivables** are amounts owed by customers on account
 - result from the sale of goods and services
 - generally expected to be collected within 30 days
 - classified as current assets
- **notes receivables** are claims where formal instruments of credit - a written promise to repay - issued as evidence of the debt
 - requires the debtor to pay interest
 - for 30 days or longer
 - current assets or non current assets
 - **trade receivables** are notes and accounts receivables that exults from sales transactions
- **other receivables** includes interest receivables, loans to company officers, advances to employees and recoverable sales tax and income tax

Recognizing Accounts Receivable

- service companies - receivables are recorded when a service is provided **on account**
- merchandising companies - a receivable is recorded at the point of sale of merchandise on account
- revenue and related receivables should be recognized when sales efforts are substantially complete
 - occurs when the service is performed or when goods are delivered at the point of sale
- receivables are created by services or sales on account
 - reduced when cash is collected or customers take advantage of

sales discounts/ returns

Accounts Receivable Subsidiary Ledger

- **subsidiary ledger** is a group of accounts that share a common characteristic
 - has a receivable account for each customer
 - totals balance in the customer accounts (in subsidiary ledger) should equal the total balance in the general ledger
 - when receivables are recorded on a customer by customer basis, summaries of transactions are recorded on the general ledger
 - provides supporting details to the general ledger
 - accounts supported by subsidiary ledgers
 - inventory, accounts payable, payroll
- general ledger contains one receivable account
 - acts as a control account to subsidiary ledgers
- **control accounts** is a general ledger account that summarizes the subsidiary ledger data
 - control account must equal the total of all the individual customer receivable balances in the subsidiary ledger
- journal entries affects accounts receivables must be posted twice - once to the subsidiary ledger and once to the general ledger

Interest Revenue

- companies use subsidiary ledgers to determine transaction in each customers' account
 - happens at the end of the period
 - sends the customer statement of transactions occurring that month
- if payment is not paid within 30 days, interest charges apply
- financing charges that apply
 - seller recognizes interest revenue
 - increases accounts receivable amount owed by customer

Valuing Accounts Receivable

- each customer should be able to satisfy the sellers credit requirements before credit sales are approved
- accounts receivables may become uncollectible
- credit losses from uncollectible receivables are debited to Bad Debts Expense
 - Bad Debts Expense is used instead of debiting a contra sales

account

- expense accounts are used because granting credit and collecting accounts are separated from sales and marketing
- key issue in valuing accounts receivables
 - when to recognize expenses
 - reporting in the wrong period could cause overstatements or understatements
- **allowance method** of accounting for bad debts estimates the uncollectible accounts at the end of each period
 - shows this estimate in Allowance for Doubtful Accounts
 - a contra asset account, a credit balance
 - allowance is an estimate of the amount of receivables that are expected to become uncollectible in the future
- why is a contra account used?
 - we do not know who will not pay
 - using a subsidiary ledger, we are unable to credit specific customer accounts to show they are uncollectible
 - unable to credit the control account
 - balance in the allowance for doubtful accounts is an estimate
 - contra accounts help to separate estimates from actual amounts
- **net realizable value** Accounts receivable value - allowance for doubtful accounts
 - the collectible portion of accounts
 - allowance has a credit balance -> when increased, offsetting debit is recorded in bad debts expense
- 3 FEATURES
 - **recording estimated uncollectible amounts**
 - is estimated by ensuring the balance in allowance for doubtful accounts = to estimate of uncollectible accounts
 - increase to allowance is recorded in the bad debts expense account
 - therefore, recorded in the same period related revenue is earned
 - **recording the write-off of an uncollectible account**
 - uncollectibles are written off at the time it is determined
 - result: reduction in accounts receivable, account is not collectible

- reduction in allowance for doubtful accounts -> account is no longer doubtful
- **recording the recovery of an uncollectible account**
 - when the previously written off account is collected, original write off is reversed
 - collection is then recorded
 - does not affect the income statement

Recording Estimated Uncollectible Accounts

- 1.2 million dollars in credit sales
- \$200,000 remains uncollected at december 31
- estimated bad debts expense - \$10,000
- Adjusting Entry
 - Bad Debts Expense is debited for 10,000
 - Allowance for Doubtful Accounts is credited for 10,000
- bad debts expense is recorded as an operating expense on the income statement

Dec. 31	Bad Debts Expense	10,000	
	Allowance for Doubtful Accounts		10,000
	(To record estimate of uncollectible accounts)		

Accounts receivable	\$200,000
Less: Allowance for doubtful accounts	11,000
Net realizable value	<u>\$189,000</u>

Accounts Receivable	-	Allowance for Doubtful Accounts	=	Net Realizable Value
\$200,000	-	\$11,000	=	\$189,000

Estimating the Allowance

- most companies use a percentage of their outstanding receivables to determine allowance for doubtful accounts
- **percentage of receivables basis** management estimates the percentage of receivables that is likely to be uncollectible
 - percentage can be assigned to receivables in total or divided by ages of the receivables
 - dividing the percentages classifies customer balances by length

of time they've been unpaid

- improves reliability of estimate
- using stratification (dividing up) is known as **aging the accounts receivable**
- expected allowance amount for doubtful accounts determined by percentages of totals of past categories
 - longer the receivable is past due -> less likely to be collected
 - estimated percentage of uncollectible debts increases each day passing

Customer	Number of Days Outstanding					
	Total	0-30	31-60	61-90	91-120	Over 120
Adert Limited	\$ 6,800	\$ 3,800	\$ 3,000			
Bortz Corporation	12,200	8,700	3,500			
B. Carl	9,400	6,400	3,000			
Diker Furnishings Ltd.	36,600	22,400	8,600	\$ 4,000	\$1,600	
T. Ebbet	2,500					\$2,500
Others	132,500	70,200	23,300	34,000	5,000	
	\$200,000	\$111,500	\$41,400	\$38,000	\$6,600	\$2,500
Estimated percentage uncollectible		2%	5%	10%	25%	50%
Total estimated allowance for doubtful accounts	\$ 11,000	\$ 2,230	\$ 2,070	\$ 3,800	\$1,650	\$1,250

- \$11, 000 - is the total estimated allowance for doubtful accounts
 - is the amount of existing receivables expected to be uncollectible in the future
 - amount of the balance in account
- **amount of the bad debts adjusting entry is the difference between the required balance and existing balance in the allowance account**

Dec. 31	Bad Debts Expense	10,000	
	Allowance for Doubtful Accounts		10,000
	(To record estimate of uncollectible accounts)		

Bad Debts Expense		Allowance for Doubtful Accounts	
Dec. 31.	Adj. 10,000	Jan. 1	Bal. 1,000
		Dec. 31	Adj. 10,000
		Dec. 31	Bal. 11,000

- when allowances have debit balances before adjustments

- occurs when write offs during the year exceed previous estimates for bad debts
- opening debit balance is added to required balance when adjusting entry is made

Recording the Write Off of an Uncollectible Account

- methods of collecting past due accounts
 - letters
 - phone calls
 - collection agencies
 - legal action
- when ways of collecting past due accounts have been tried, accounts should be written off and removed from the allowance
 - no longer and doubt about collection
- preventing premature or unauthorized write offs
 - each write off should be approved formally by authorized management personnel

Mar. 1	Allowance for Doubtful Accounts	2,500	
	Accounts Receivable—T. Ebbet		2,500
	(Write-off of T. Ebbet account)		

- allowance method, **every accounts receivable write off entry is debited to the allowance account instead of to the Bad Debts Expense**
- entries that record write offs of uncollectible accounts reduces **both accounts receivables and allowance for doubtful accounts**

Accounts Receivable			Allowance for Doubtful Accounts						
Feb. 28	Bal.	227,500	Mar. 1	2,500	Mar. 1	2,500	Jan. 1	Bal.	11,000
Mar. 1	Bal.	225,000					Mar. 1	Bal.	8,500

- write offs affect only the statement of financial position accounts - reduces AR and Allowance for doubtful accounts

	Before Write-Off	After Write-Off
Accounts receivable	\$227,500	\$225,000
Less: Allowance for doubtful accounts	11,000	8,500
Net realizable value	\$216,500	\$216,500

- when the allowance account ends off with a debit balance after a write

off of an uncollectible account

- occurs if the write offs during the period exceed the opening balance

Recording the Recovery of an Uncollectible Account

- companies collect from a customer after accounts have been written off as uncollectible
- two required entries
 - an entry is made in writing off the account is reversed to reinstate the customers' account
 - collection is recorded

(1)			
July 1	Accounts Receivable—T. Ebbet	2,500	
	Allowance for Doubtful Accounts		2,500
	(To reverse write-off of T. Ebbet account)		

(2)			
1	Cash	2,500	
	Accounts Receivable—T. Ebbet		2,500
	(To record collection from T. Ebbet)		

- net effect of two entries
 - increase to cash (a debit)
 - increase to Allowance for Doubtful Accounts (credit)
 - AR is debited and later credited in a second entry
 - reversing the write off as soon as the receivable is considered collectible

Summary of Allowance Method

- three types of transactions
 - estimated uncollectible accounts receivable are recorded at the end of the period
 - by debiting bad debts expense
 - crediting allowance for doubtful accounts
 - recording amount is determined by using a percentage of total receivables or aging schedule
 - entry is made at the end of the period
 - actual uncollectibles or write offs are debited to allowance for doubtful accounts and credited to AR

- entry is made as soon as it can be determined collection of an account is unlikely
- later recoveries are recorded in two entries
 - first - reverse write off by
 - debiting AR
 - crediting Allowance for doubtful accounts
 - second - records normal collection by
 - debiting cash
 - crediting AR

Notes Receivables

- **promissory note** a written promise to pay a specified amount of money on demand or at a definite time
 - used when individuals and companies lend or borrow money
 - used when the amount of the transaction and length of credit period exceeds normal limits
 - used in settlement of accounts receivable
- party making the promise to pay is known as the **maker**
 - note is classified as a note payable
- party who will be paid is known as the **payee**
 - note is classified as a note receivable
- note details the names of maker and payee
 - principle/face value of loan
 - loan period
 - interest rate
 - if interest is payable monthly or at maturity with principle amount
- **note receivable** a formal promise to pay an amount bearing interest from the time it is issued till it is due
 - account receivables are informal promises bearing interest only after its due date
 - has no strong legal claim as a note receivable
 - are usually due within a short period of time
 - note receivables are usually due over a longer period of time
- similarities between note receivables and accounts receivables
 - are both credit instruments
 - can be sold to another party
 - valued at their net realizable value

Recognizing Notes Receivables and Interest Revenue

- payee accepts a note receivable in exchange for an account receivable

from the maker

- note is for \$10,000 with 6% interest due in four months

May 1	Notes Receivable—Raja	10,000	
	Accounts Receivable—Raja		10,000
	(To record acceptance of Raja note)		

- note exchanged for cash
 - entry is debited to notes Receivable
 - Credit to Cash for the amount of the loan
- principle value is the value shown on the face of the note

Face Value of Note	×	Annual Interest Rate	×	Time in Terms of One Year	=	Interest
\$10,000	×	6%	×	4/12	=	\$200

- interest revenue is note reported when the note is accepted
- interest rate specified on notes are **annual rates of interest**
- long term notes are repayable in instalments rather than at maturity
 - short term notes may also be paid in instalments

May 31	Interest Receivable	50	
	Interest Revenue		50
	(To accrue interest on Raja note receivable)		

- interest on an overdue account receivable is debited to AR
- interest on a note receivable is not debited to Notes Receivable
 - separate accounts are made for the interest receivable used
- notes held to their maturity date which the principle plus accrued interest is due is known as honouring the note (collecting)
- when the maker of the note defaults and an appropriate adjustment is made it is known as dishonouring the note (not collecting)

Honouring of Notes Receivables

- when a note is paid in full at its maturity date it is being honoured

Sept. 1	Cash	10,200	
	Notes Receivable—Raja		10,000
	Interest Receivable		50
	Interest Revenue		150
	(To record collection of Raja note and interest)		

Dishonouring of Notes Receivables

- **dishonoured notes** a note that is not paid in full at its maturity date
- is no longer negotiable
- payee still has a claim against the maker of the note for the principle and unpaid interest
- notes receivable account balance and related interest are transferred to accounts receivable
 - debit AR for total of the principle amount and of the note and interest due

Sept. 1	Accounts Receivable	10,200	
	Notes Receivable—Raja		10,000
	Interest Receivable		50
	Interest Revenue		150
	(To record dishonoured Raja note; eventual collection expected)		

- no hope of collection, principal and accrued interest should be written off

Sept. 1	Allowance for Doubtful Accounts (Notes)	10,050	
	Notes Receivable—Raja		10,000
	Interest Receivable		50
	(To write off dishonoured Raja note)		

Valuing Notes Receivables

- notes receivables are reported at their **net realizable value**
- notes are analyzed to determine its probability of collection

Statement of Presentation of Receivables

Statement of Financial Position

- short term receivables are reported in the current assets of the statement of financial position section
- it follows after cash and short term investments



Note 3: Accounts Receivable

	<u>2010</u>	<u>2009</u>
Subscriber and trade receivables	\$209,817	\$204,786
Due from officers and employees	148	843
Due from related parties	1,689	682
Miscellaneous receivables	3,730	5,333
	<u>215,384</u>	<u>211,644</u>
Less: Allowance for doubtful accounts	<u>18,969</u>	<u>17,161</u>
	<u>\$196,415</u>	<u>\$194,483</u>

Income Statement

- includes the revenue generated from sales or services on account
- Bad debts expense is reported under operating expenses of the income statement
- interest revenues is recorded under revenues on the income statement

Managing Receivables

- 5 steps
 - determine who to extend credit to
 - establish a payment period
 - monitor collections
 - evaluate the liquidity of receivables
 - accelerate cash receipts from receivables when necessary

Extending Credit

- it is crucial to pick the right people to extend credit to
- if a companies credit policy is too tight, the company could risk the loss of sales
- if a companies credit policy is too loose it may sell to those who will pay very late or not at all
- to minimize the risk of losses
 - risky customers may be required to provide letters of credit or guarantees
 - if the customer does not pay the company providing the guarantee will pay
 - may be required to pay a deposit in advance
- references should be asked for from banks and suppliers in order to determine payment history

Establishing a Payment Period

- periods are usually similar to that of the period used by competitors
- if the period ends up being shorter the company could risk the loss of sales
- if the period is longer, the slower receipt of cash from customers may require the company to carry higher levels of debt

Monitoring Collections

- accounts receivable aging schedule should be prepared and reviewed
- aging schedules help estimate the timing of future cash inflows when preparing a cash budget
 - provides information about the company's overall collection experience
 - identifies problem accounts
- credit risk increases during period of economic downturn
- credit risk is important when a company has a high level of receivables from few customers
- **concentration of credit risk** when a company sells services or product to only a few number of customers

Evaluating Liquidity of Receivables

- if AR rises faster than sales it is an indication of collection problems
- receivables may be difficult to collect in this case
- these receivables are considered less liquid
 - measured by how quickly certain assets can be converted to cash
- **receivables turnover ratio** is used to assess the liquidity of receivables
- measures the number of times on average that receivables are collected during the year
- $\text{RECEIVABLES TURNOVER} = \frac{\text{NET CREDIT SALES (OR NET SALES)}}{\text{AVG. GROSS ACCOUNTS RECEIVABLE}}$
- net credit sales is rarely reported on financial statements
- **average collection period** is a variant of the receivables turnover ratio
- $\text{AVERAGE COLLECTION PERIOD} = \frac{365 \text{ DAYS}}{\text{RECEIVABLES TURNOVER}}$
- alternate way of calculating the average collection period is by $\frac{\text{ACCOUNTS RECEIVABLE}}{\text{AVG AMOUNT OF NET CREDIT SALES PER DAY}}$
- is used to assess the effectiveness of a company's credit and

collection policies

- these ratios can be used to detect error

Accelerating Cash Receipts

- accelerating the receipt of cash from receivables

Loans Secured by Receivables

- borrowing money from a bank by using receivables as collateral
- although interest must be paid to the bank on the loan, cash becomes available for the companies to use earlier
- the loan can be repaid when the receivables are collected
- banks are willing to provide financing for up to 75% of receivables less than 90 days old
- occurs through a credit facility or operating line of credit

Sale of Receivables

- when a company sells their receivables to another company for cash -
> this shortens the cash to cash operating cycle
- reasons for the sale of receivables
 - Size of the business - establishing a financing subsidiary that buys accounts receivables from the company -> the company's statement of financial position appears more liquid because there are no accounts receivables
 - selling receivables provides a source of immediate cash flow for the company
 - allows the company to save costs - monitoring and collection of receivables
- Two Types of Sales
 - **Securitization of Receivables**
 - transferring receivables to investors in return for cash is known as **securitization**
 - transfer may be treated as a sale of receivables or a secured loan
 - speeds up collection
 - **Factoring Receivables**
 - sale to a factor
 - **factor** is a finance company or bank which buys receivables from businesses for a fee
 - if customers do not pay, the company is then responsible for paying back the factor for uncollected amounts
 - securitization involves investors, cost is lower and

receivables are higher quality and sellers tend to have involvement with receivables

- factoring - involves one to one company, costs are higher, receivables are of lower quality, sellers do not have any involvement with receivables