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MANARA UNIVERSITY

Accounting: Tools for Business Decision Making

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Chapter 8

Reporting and Analyzing Receivables

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Chapter Outline:

Learning Objectives

LO 1 Explain how companies recognize accounts receivable.

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

LO 3 Explain how companies recognize, value, and dispose of notes receivable.

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

Learning Objective 1

Explain How Companies Recognize Accounts Receivable

Types of Receivables (1 of 2)

- Amounts due from individuals and companies that are expected to be collected in cash.
  - **Accounts Receivable:** Amounts customers owe on account that result from the sale of goods and services.
  - **Notes Receivable:** Written promise (formal instrument) for amount to be received.
  - **Other Receivables:** Nontrade receivables such as interest, loans to officers, advances to employees, and income taxes refundable.

Types of Receivables (2 of 2)

Amounts due from individuals and companies that are expected to be collected in cash.

Company	Receivables as a Company Percentage of Total Assets
Ford Motor Company	43.2%
General Electric	41.5
Minnesota Mining and Manufacturing Company (3M)	12.7
DuPont Co.	11.7
Intel Corporation	3.9

Recognizing Accounts Receivable (1 of 6)

- **Service organizations** record a receivable when they perform service on account
- **Merchandisers** record accounts receivable at point of sale of merchandise on account
- Seller may offer a discount to encourage early payment
- Buyer might return goods found to be unacceptable
  - Sales returns reduce receivables

Recognizing Accounts Receivable (2 of 6)

Illustration: Assume that Jordache Co. on July 1, 2022, sells merchandise on account to Polo Company for $1,000 terms 2/10, n/30. Prepare the journal entry to record this transaction on the books of Jordache Co.

Jul. 1	Accounts Receivable	1,000	
	Sales Revenue		1,000

Recognizing Accounts Receivable (3 of 6)

Illustration: On July 5, Polo returns merchandise worth $100 to Jordache Co.

Jul. 5	Sales Returns and Allowances	100	
	Accounts Receivable		100

Recognizing Accounts Receivable (4 of 6)

Illustration: On July 11, Jordache receives payment from Polo Company for the balance due.

Jul. 11	Cash ($900 – $18)	882	
	Sales Discounts ($900 × .02)	18	
	Accounts Receivable		900

Recognizing Accounts Receivable (5 of 6)

Illustration: Some retailers issue their own credit cards. Assume that you use your JCPenney Company credit card to purchase clothing with a sales price of $300 on June 15.

Jun. 15	Accounts Receivable	300	
	Sales Revenue		300

Recognizing Accounts Receivable (6 of 6)

If you still owe the $300 from the June 15 transaction at the end of the month, JCPenney charges interest of 1.5% per month on the balance due. JCPenney makes an adjusting entry to record interest revenue on June 30 as follows.

Jun. 15	Accounts Receivable	2.25	
	Interest Revenue		2.25
	$(\$300 \times 1.5\% \times \frac{1}{2})$		

Do It! 1: Recognizing Accounts Receivable (1 of 3)

On May 1, Wilton sold merchandise on account to Bates for $50,000 terms 3/15, net 45. On May 4, Bates returns price of $2,000. On May 16, Wilton receives payment from Bates for the balance due. Prepare journal entries to record the May transactions on Wilton's books. (Ignore cost of goods sold entries.)

May 1	Accounts Receivable	50,000	
	Sales Revenue		50,000

Do It! 1: Recognizing Accounts Receivable (2 of 3)

On May 1, Wilton sold merchandise on account to Bates for $50,000 terms 3 / 15, net 45. On May 4, Bates returns merchandise with a sales price of $2,000. On May 16, Wilton receives payment from Bates for the balance due. Prepare journal entries to record the May transactions on Wilton's books. (Ignore cost of goods sold entries.)

May 4	Sales Returns and Allowances	2,000	
	Accounts Receivable		2,000

Do It! 1: Recognizing Accounts Receivable (3 of 3)

On May 1, Wilton sold merchandise on account to Bates for $50,000 terms 3/15, net 45. On May 4, Bates returns merchandise with a sales price of $2,000. On May 16, Wilton receives payment from Bates for the balance due. Prepare journal entries to record the May transactions on Wilton’s books. (Ignore cost of goods sold entries.)

May 16	Cash ($48,000 – $1,440)	46,560	
	Sales Discounts ($48,000 × .03)	1,440	
	Accounts Receivable		48,000

Learning Objective 2

Describe How Companies Value Accounts Receivable and Record Their Disposition

Valuing Accounts Receivable

- Valued at net realizable value
- Uncollectible accounts receivable
  - Sales on account raise possibility of accounts not being collected
  - Seller records losses that result from extending credit
    - Reported as Bad Debt Expense

Accounting for Uncollectible Accounts

Direct Write-Off Method

- No matching
- Receivable not stated at net realizable value
- Not acceptable for financial reporting

Allowance Method

- Better matching
- Receivable stated at net realizable value
- Required by GAAP

Direct Write-Off Method for Uncollectible Accounts

Illustration: Assume that Warden Co. writes off M. E. Doran's $200 balance as uncollectible on December 12. Warden's entry is:

Bad Debt Expense	200	
Accounts Receivable		200

Not acceptable for financial reporting unless bad debt losses are insignificant.

Features of the Allowance Method for Uncollectible Accounts

- **Estimate** uncollectible accounts receivable
- Debit Bad Debt Expense and credit Allowance for Doubtful Accounts
  - Credit is to a contra-asset account
- At the time the specific account is written off as uncollectible
  - Debit Allowance for Doubtful Accounts
  - Credit Accounts Receivable

Allowance Method for Uncollectibles (1 of 4)

Recording Estimated Uncollectibles

Illustration: Hampson Furniture has credit sales of $1,200,000 in 2022, of which $200,000 remains uncollected at December 31. The credit manager estimates that $12,000 of these sales will prove uncollectible.

Dec. 31	Bad Debt Expense	12,000	
	Allowance for Doubtful Accounts		12,000

Allowance Method for Uncollectibles (2 of 4)

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

Allowance Method for Uncollectibles (3 of 4)

Write-Off of an Uncollectible Account

Illustration: On March 1, 2023, Hampson Furniture writes-off $500 owed by R. A. Ware. The entry to record the write-off is:

Mar. 1	Allowance for Doubtful Accounts	500	
	Accounts Receivable		500

Accounts Receivable								Allowance for Doubtful Accounts							
Jan. 1		Bal.	200,000	Mar. 1			500	Mar. 1			500	Jan. 1		Bal.	12,000
Mar. 1		Bal.	199,500									Mar. 1		Bal.	11,500

Allowance Method for Uncollectibles (4 of 4)

Recovery of an Uncollectible Account

Illustration: On July 1, R. A. Ware pays the $500 amount that Hampson Furniture had written off on March 1. Hampson makes these entries:

July 1	Accounts Receivable	500	
	Allowance for Doubtful Accounts		500
	Cash	500	
	Accounts Receivable		500

Note Disclosure of the Allowance Method

Nike, Inc.

Notes to the Financial Statements

Allowance for Uncollectible Accounts Receivable

Accounts receivable, net consist primarily of amounts receivable from customers. The Company makes ongoing estimates relating to the collectability of its accounts receivable and maintains an allowance for estimated losses resulting from the inability of its customers to make required payments. In determining the amount of the allowance, the Company considers historical levels of credit losses and makes judgments about the creditworthiness of significant customers based on ongoing credit on evaluations. Accounts receivable with anticipated collection dates greater than 12 months from the balance sheet date and related allowances are considered non-current and recorded in *Deferred income taxes and other assets*. The allowance for uncollectible accounts receivable was $19 million and $43 million at May 31, 2017 and 2016, respectively.

Estimating the Allowance Using the Percentage-of-Receivables Basis

- Basing estimates on outstanding receivables
  - Management establishes a percentage relationship between amount of receivables and expected losses from uncollectible accounts
- Amount of bad debt expense to be recorded is difference between
  - Required balance and
  - Existing balance in allowance account

Aging Accounts Receivable

Worksheet

Home Insert Page Layout Formulas Data Review View

P18 fx

	A	B	C	D	E	F	G
1				Number of Days Past Due			
2			Not				
3	Customer	Total	Yet Due	1–30	31–60	61–90	Over 90
4	T. E. Adert	$ 600		$ 300		$ 200	$ 100
5	R. C. Bortz	300	$ 300				
6	B. A. Carl	450		200	$ 250		
7	O. L. Diker	700	500			200	
8	T. O. Ebbet	600			300		300
9	Others	36,950	26,200	5,200	2,450	1,600	1,500
10		$39,600	$27,000	$5,700	$3,000	$2,000	$1,900
11	Estimated percentage uncollectible		2%	4%	10%	20%	40%
12	Total estimated uncollectible accounts	$ 2,228	$ 540	$ 228	$ 300	$ 400	$ 760
13							

Recording the Allowance Estimate (1 of 2)

Illustration: The unadjusted trial balance shows Allowance for Doubtful Accounts with a **credit** balance of $528. Prepare the adjusting entry assuming $2,228 is the estimate of uncollectible receivables from the aging schedule.

		Debit	Credit
Dec. 31	Bad Debt Expense	1,700	
	Allowance for Doubtful Accounts		1,700

Bad Debt Expense

Debit	Credit
Dec. 31 Adj. 1,700	

Allowance for Doubtful Accounts

Debit	Credit
	Dec. 31 Unadj. Bal. 528
	Dec. 31 Adj. 1,700
	Dec. 31 Bal. 2,228

Recording the Allowance Estimate (2 of 2)

Illustration: Assume the unadjusted trial balance shows Allowance for Doubtful Accounts with a **debit** balance of $500. Prepare the adjusting entry assuming $2,228 is the estimate of uncollectible receivables.

Dec. 31	Bad Debt Expense	2,728	
	Allowance for Doubtful Accounts		2,728

Bad Debt Expense

Debit			Credit
Dec. 31	Adj.	2,728	

Allowance for Doubtful Accounts

Debit			Credit		
Dec. 31	Unadj. Bal.	500	Dec. 31	Adj.	2,728
			Dec. 31	Bal.	2,228

Disclosure of Accounts Receivable

Skechers USA

Notes to the Financial Statements

The likelihood of a material loss on an uncollectible account would be mainly dependent on deterioration in the overall economic conditions in a particular country or region. Reserves are fully provided for all probable losses of this nature. For receivables that are not specifically identified as high risk, we provide a reserve based upon our historical loss rate as a percentage of sales. Gross trade accounts receivable were $368.5 million and $368.2 million, and the allowance for bad debts, returns, sales allowances and customer chargebacks were $41.6 million and $24.3 million, at December 31, 2016 and 2015, respectively. Our credit losses charged to expense for the years ended December 31, 2016, 2015 and 2014 were $12.7 million, $5.3 million, and $11.8 million, respectively. In addition, we recorded sales return and allowance expense for the years ended December 31, 2016, 2015 and 2014 of $18.1 million, $2.3 million, and $2.3 million, respectively.

Do It! 2a: Bad Debt Expense

Brule Co. has been in business five years. The unadjusted trial balance at the end of the current year shows:

Accounts Receivable	$30,000 Dr.
Sales Revenue	$180,000 Cr.
Allowance for Doubtful Accounts	$2,000 Dr.

Bad debts are estimated to be 10% of receivables. Prepare the entry to adjust Allowance for Doubtful Accounts.

Bad Debt Expense	5,000*	
Allowance for Doubtful Accounts		5,000

$* \; [(10\% \times \$30,000) + \$2,000]$

Sale of Receivables to a Factor (1 of 2)

- A method of disposing of accounts receivable
- Receivables are sold to a finance company or bank
    - Factors buys receivables from businesses and then collect payments directly from customers
    - Typically charges a commission to company that is selling receivables
        - Fee ranges from 1% to 3% of receivables purchased

Sale of Receivables to a Factor (2 of 2)

Illustration: Assume that Hendredon Furniture factors $600,000 of receivables to Federal Factors. Federal Factors assesses a service charge of 2% of the amount of receivables sold.

Journal entry to record the sale by Hendredon Furniture

Cash	588,000	
Service Charge Expense	12,000	
Accounts Receivable		600,000

($600,000 × 2% = $12,000)

National Credit Card Sales (1 of 2)

- A method of disposing of accounts receivable
- Retailer pays card issuer a fee of 2 to 4% of invoice price
- Recorded 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

National Credit Card Sales (2 of 2)

Illustration: Anita Ferreri purchases $1,000 of sound equipment for her restaurant from Karen Kerr Music Co., using her Visa First Bank Card. First Bank charges a service fee of 3%.

Journal entry to record the sales

Cash	970	
Service Charge Expense	30	
Sales Revenue		1,000

($1,000 × 3% = $30)

Do It! 2b: Factoring

Peter M. Kell Wholesalers Co. needs to raise $120,000 in cash to safely cover next Friday's employee payroll. Kell has reached its debt ceiling. Kell's present balance of outstanding receivables totals $750,000. Kell decides to factor $125,000 of its receivables on September 7, 2022, to alleviate this cash crunch. Record the entry that Kell would make when it raises the needed cash. (Assume a 1% service charge.)

Cash	123,750	
Service Charge Expense	1,250	
Accounts Receivable		125,000

($125,000 × 1% = $1,250)

Learning Objective 3

Explain How Companies Recognize, Value, and Dispose of Notes Receivable

Nature of Notes Receivable

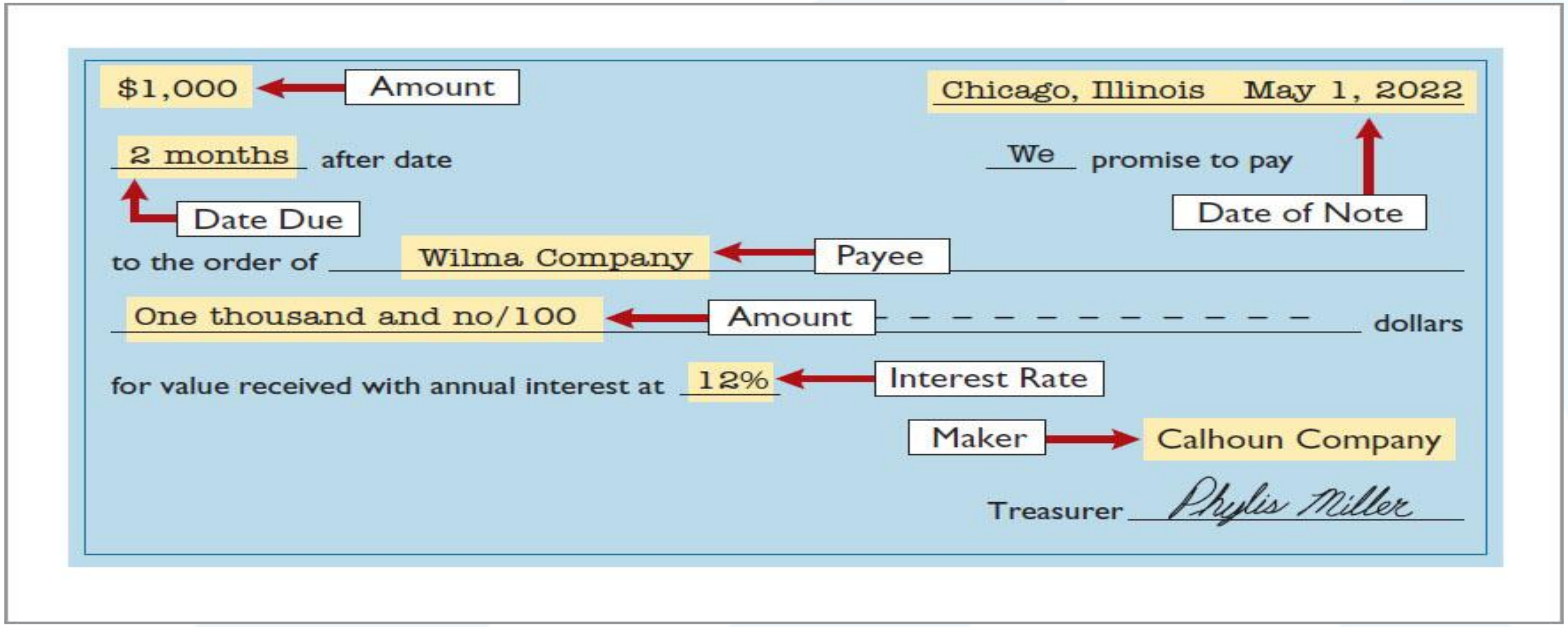
Companies may grant credit in exchange for a promissory note.

- A **Promissory note** is a written promise to pay a specified amount of money on demand or at a definite time.
- Promissory notes may be used
  - When lending or borrowing money
  - When amount of transaction and credit period exceed normal limits
  - In settlement of accounts receivable

Notes Receivable

To the **payee**, the promissory note is a **note receivable.**

To the **maker**, the promissory note is a **note payable.**



Determining the Maturity Date

Maturity date of a promissory note may be stated in one of three ways

- On demand
- On a stated date
- At the end of a stated period of time

Note terms are expressed in

- Months
- Days

Computing Interest

Face Value of Note × Annual Interest Rate × Time in Terms of One Year = Interest

When counting days, omit date note is issued, but include due date

Terms of Note			Interest Computation							
			Face	×	Rate	×	Time	=	Interest
$ 730,	12%,	120 days	$ 730	×	12%	×	**120/360**	=	$ 29.20
$1,000,	9%,	6 months	$1,000	×	9%	×	**6/12**	=	$ 45.00
$2,000,	6%,	1 year	$2,000	×	6%	×	**1/1**	=	$120.00

Recognizing Notes Receivable

Illustration: Calhoun Company wrote a $1,000, two-month, 12% promissory note dated May 1, to settle an open account. Prepare the entry Wilma Company makes for the receipt of the note.

May 1	Notes Receivable	1,000	
	Accounts Receivable		1,000

Disposing of Notes Receivable (2 of 2)

Honor of Notes Receivable

- A note is **honored** when its maker pays it in full at its maturity date.

Dishonor of Notes Receivable

- A **dishonored note** is not paid in full at maturity.
- Dishonored note receivables are no longer negotiable

Honor of Notes Receivable

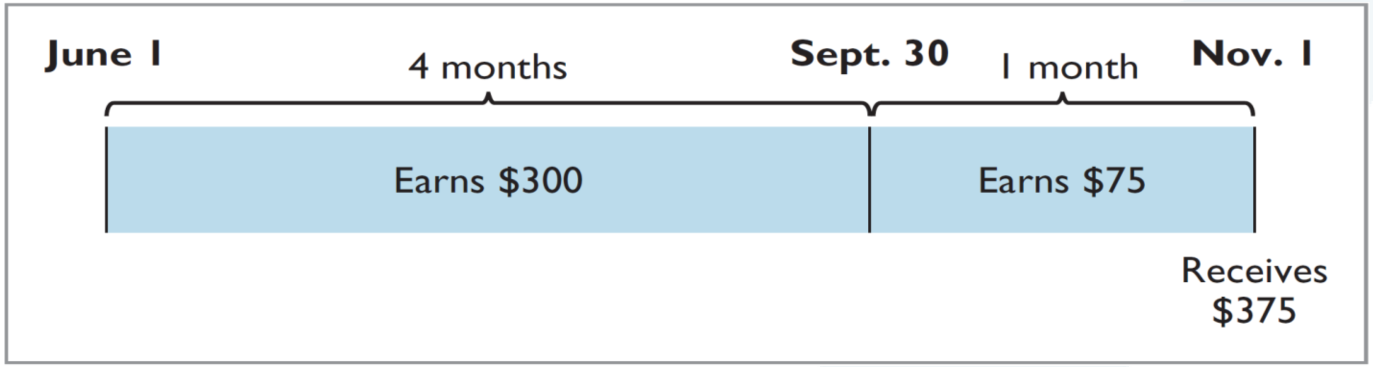
Illustration: Wolder Co. lends Higley Inc. $10,000 on June 1, accepting a five-month, 9% interest note. If Wolder presents the note to Higley Inc. on November 1, the maturity date, Wolder's entry to record the collection is:

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

$$(\$10,000 \times 9\% \times \frac{5}{12} = \$375)$$

Accrual of Interest Receivable (1 of 2)

Illustration: Suppose instead that Wolder Co. prepares financial statements as of September 30. The adjusting entry by Wolder is for four months ending Sept. 30.



Sept. 30	Interest Receivable	300	
	Interest Revenue		300

$$(\$10{,}000 \times 9\% \times \frac{4}{12} = \$300)$$

Accrual of Interest Receivable (2 of 2)

Illustration: Prepare the entry Wolder's would make to record the honoring of the Higley note on November 1.

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

$$(\$10{,}000 \times 9\% \times \frac{1}{12} = \$75)$$

Dishonor of Notes Receivable (1 of 2)

Illustration: Assume that Higley Co. on November 1 indicates that it cannot pay at the present time. If it does expect eventual collection, Wolder Co. would make the following entry at the time the note is dishonored assuming no previous accrual of interest.

Nov. 1	Accounts Receivable	10,375	
	Notes Receivable		10,000
	Interest Revenue		375

Dishonor of Notes Receivable (2 of 2)

Illustration: If instead on November 1 there is no hope of collection, the note holder would write off the face value of the note by making the following entry at the time the note is dishonored assuming no previous accrual of interest.

Nov. 1	Allowance for Doubtful Accounts	10,000	
	Notes Receivable		10,000

Do It! 3: Recognizing Notes Receivable

Gambit Stores accepts from Leonard Co. a $3,400, 90-day, 6% note dated May 10 in settlement of Leonard's overdue open account. The note matures on August 8. What entry does Gambit make at the maturity date, assuming Leonard pays the note and interest in full at that time?

Solution

Interest payable at maturity date = $\$3,400 \times 6\% \times \frac{90}{360} = \mathbf{\$51}$

Cash	3,451	
Notes Receivable		3,400
Interest Revenue		51