CLASSIFICATION OF RECEIVABLES

Receivables: Includes all money clams against other entities, including people, business firms, and other organization.

- ***Accounts receivable:*** *The most common transaction creating a receivable is selling merchandise or services on credit. The receivable is recorded as a debit to the accounts receivable account. Accounts receivable are normally expected to be collected within a relatively short period, such as 30 or 60 days. They are classified on the balance sheet as a current asset.*
- ***Notes receivable:*** *Are amounts that customers owe for which a formal, written instruction of credit has been issued. It's classified as a current asset if it can be collected within a year.*

UNCOLLECTIBLE RECEIVABLES

Bad debt expense: The operating expense recorded from uncollectible accounts receivables. Accounts become uncollectible when a customer does not pay after a specified period, declares bankruptcy, or dies. Companies use several different methods to recognize the uncollectible account as follows:

- ***Direct write-off method****: Records bad debt expense only when an account is judged to be worthless.*

DIRECT WRITE-OFF METHOD

When an account becomes uncollectable we write the account off to bad debt expense. This removes the receivable and recognizes an expense in the period in which it becomes uncollectable.

- *Assume that on March 3rd, a $4,200 account receivable from Rosalyn Monte has been determined to be uncollectible. The entry to write off each individual account as it becomes uncollectible is:*

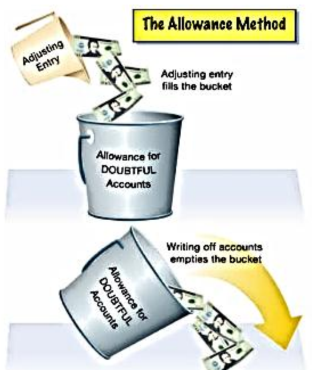
General Journal			Page 1
3-3	Bad Debt Expense	4,200	
	Accounts Receivable-Monte		4,200

This reduces Rosalyn Monte's account to zero and recognizes the expense.

Accounts Receivable		Bad Debt Expense	
538,000	*4,200*	*4,200*	
533,800			

<u>The problem with this method is that it does not match the revenues with the expenses in the same period.</u>

ALLOWANCE METHOD



When we use the allowance method for uncollectable accounts, the company is following the idea of the matching concept. The matching concept requires us to match the revenues earned with the expenses incurred to earn them

- ***Allowance method:*** *Records bad debt expense by estimating uncollectible accounts at the end of the accounting period.*
  - ***Allowance for Doubtful Accounts:*** *The contra asset is used to recognize the decrease in the accounts receivable account rather than reducing the balance directly.*

When a fisherman goes fishing, he must first get bait. The credit adjustment to the Allowance account fills our Allowance (bait) bucket with our estimated uncollectible. Throughout the accounting period as accounts become uncollectible, we simply debit the allowance account and zero out their accounts receivable. *We don't use the Bad Debt Expense account because we recognized all the bad debts at the beginning of the period when we did the adjustment.*

Analysis Of Receivables Method

(Aging Of Receivables)

The analysis of receivables method is based on the assumption that the longer an account receivable is outstanding, the less likely that it will be collected.

Receivables *are grouped by the length of time outstanding and then each age group is multiplied by the percentage that is believed to become uncollectible.*

Percentage Of Sales Method

This method estimates the expected uncollectable amount based on industry averages or past history. If Azteck Co, found that 2% of all sales in 2012 became uncollectible, 1.98%, in 2011 and 2.1% in 2010, then they can use 2% as a realistic expectation of what will become uncollectible in the current year.

(2% + 1.98% + 2.1% = 6.08% ÷ 3 = 2.026666667 = 2%)

Azteck Co. had a balance in accounts receivable of $538,000, and based upon the aging schedule it is determined that on our percentage they estimate that $26,490 will become uncollectible . (see aging schedule on page 409)

General Journal			Page 1
3-1	Bad Debt Expense	24,170	
	Allowance for Doubtful Accounts		24,170
	(26,490-2,320 = 24,170)		

This method tells us the amount of the ending balance of the allowance account. We must then determine how much to add to the allowance account to get that balance.

Accounts Receivable: *538,000* (debit)

Bad Debt Expense: *24,170* (debit)

Allowance for Doubtful Accounts

	Credit	
	2,320	Beginning Balance
	24,170	Adjustment
	26,490	Ending Balance =>26,490

The beginning balance in the allowance account is VITAL for this method.

Azteck Co. had a balance in accounts receivable of $538,000, and based on our percentage they estimate that $10,760 (538,000×2%) will become uncollectible.

General Journal			Page 1
3-1	Bad Debt Expense	10,760	
	Allowance for Doubtful Accounts		10,760

This increases the bad debt expense, and creates a balance in the allowance for doubtful accounts.

Accounts Receivable: *538,000* (debit)

Bad Debt Expense: *10,760* (debit)

Allowance for Doubtful Accounts

	Credit	
	2,320	Beginning Balance
	10,760	
	13,080	Ending Balance

The reason for this is that we must present all information fully, so this method shows both the actual balance of accounts receivable and the estimated balance of the allowance account.

The beginning balance in the allowance account is UNIMPORTANT for this method.

NOTES RECEIVABLE

A note receivable is a written promise to pay some amount at a future time with interest.
It is legal document which provides protection in case the maker fails to pay.

Characteristics of Notes Receivable

A promissory note is a written promise to pay the face amount, usually with interest, on demand or at a date in the future.

- ***Characteristics of a promissory note are:***
- *The **maker** is the party making the promise to pay.*
- *The **payee** is the party to whom the note is payable.*
- *The **face amount** is the amount for which the note is written on its face also called **principle**.*
- *The **issuance date** is the date a note is issued.*
- *The **due date or maturity date** is the date the note is to paid.*
- *The **term of a note** is the amount of time between the issuance and due dates.*
- *The **interest rate** is that rate of interest that must be paid on the face amount for the term of the note.*

Important formulas for Notes Receivables

Number of Days:

A 90 day note dated January 5, 2014 has a maturity date of? The interest rate is 6% on $10,000 note.

January 31 days	26	(31 days -5 days)
February 28 days	28	(54 days so far)
March 31 days	31	(85 days so far)
April 30 days	5	(90 days – 85 days)

Maturity Date of January 5 Note = April 5. The cash will be received on April 5th for this note.

Interest Principle × Interest Rate × Time (Term/360)
(10,000 × 6% × (90÷360) = 150

Maturity Value Principle + Interest
($10,000 + 150 = $10,150)

Dishonored Note A dishonored not is where the customer does not pay the note by the Maturity Date.

*The Principle + Interest is **transferred** to the customer's account receivable and the note receivable is reduced to zero.*

General Journal			Page 1
4-5	Accounts Receivable - Joe Nopayme	10,150	
	Notes Receivable – Joe Nopayme		10,150

REPORTING RECEIVABLES ON THE BALANCE SHEET

The accounts receivable account is always shown on the balance followed by the allowance account which provides investors a clear picture of exactly how much we think we can collect, which we call the Net Realizable Balance.

FINANCIAL ANALYSIS AND INTERPRETATION:

***Accounts Receivable Turnover** measures how frequently during the year the A/R is converted to cash.*

$$\frac{\text{Net Sales}}{\text{Average Accounts Receivables}} = \frac{3{,}375{,}200}{[(538{,}000+513{,}250)\div 2]} = \frac{3{,}375{,}200}{525{,}625} = 6.4$$

(current year + prior year)÷2 (2013 + 2012)

The A/R is collected 6.4 times a year

***Number of Days Sales in Receivables** estimates the length of time received has been outstanding.*

$$\frac{\text{Average Accounts Receivables}}{\text{Average Daily Sales}} = \frac{525{,}625}{3{,}375{,}200 \div 365} = \frac{525{,}625}{9{,}247} = 56.4$$

Sales ÷ 365

56.4 The average time it takes to collect is 56 days.