Financial Accounting

Sixth Edition

Receivables and Sales

CHAPTER 5

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PART A

RECOGNIZING ACCOUNTS RECEIVABLE

Learning Objective 1

LO5–1 Recognize accounts receivable at the time of credit sales.

Credit Sales and Accounts Receivable

- **Credit sales** transfer goods or services to a customer today while bearing the risk of collecting payment from that customer in the future.
- At the time of a credit sale, a company will record:
  - **Accounts receivable**. Accounts receivable represent amounts owed to a company by its customers from the sale of goods or services on account.
  - **Revenue**. Even though no cash is received at the time of the credit sale, the seller records revenue immediately once goods or services are provided to the customer, *and* future collection from the customer is probable.

Recording a Credit Sale

On March 1, a company provides services to a customer for $500. The customer doesn't pay cash at the time of service, but instead promises to pay the $500 by March 31.

The company records the following at the time of the service:

March 1	Debit	Credit
Accounts Receivable	**500**	
Service Revenue		**500**
(Provide services on account)		

Recording the Subsequent Receipt

On March 1, a company provides services to a customer for $500. The customer later pays the $500 by March 31.

The company records the following at the time of the service:

March 31	Debit	Credit
Cash	**500**	
Accounts Receivable		**500**
(Provide services on account)		

Key Point

- Companies record an asset (accounts receivable) and revenue when they sell goods or services to their customers on account, expecting collection in the future.
- Once the receivable is collected, the balance of accounts receivable is reduced.

Other Types of Receivables

- **Nontrade receivables**: receivables that originate from sources other than customers
  - Tax refund claims, interest receivable, and loans by the company to other entities, including stockholders and employees
- **Notes receivable**: formal credit arrangements evidenced by written debt instruments (or "notes")

Concept Check 5–1

Which of the following generally is recorded at the time a company provides services to customers on account?

a. Accounts receivable
b. Interest receivable
c. Notes receivable
d. Tax refund claims

Accounts receivable represent cash owed to the company by its customers from sales or services on account. Nontrade receivables include tax refund claims, interest receivable, and loans by the company to other entities.

Learning Objective 2

LO5–2 Calculate net revenues using returns, allowances, and discounts.

Net Revenues

- Companies often offer discounts and guarantees that can reduce the amount of cash the company is entitled to receive from those customers:
  1. Trade discounts
  2. Sales returns
  3. Sales allowances
  4. Sales discounts
- Net revenues equals total revenues less any amounts for returns, allowances, and discounts.

Trade Discounts

- Reduction in list price of a product or service
  - Used to provide incentives to larger customers or consumer groups to purchase from the company
- Because sellers are entitled to receive only the discounted amount, sale is recorded at this lower amount.

Example of a Trade Discount

- F.Y.Eye typically provides laser eye surgery for $3,000.
- The company offers laser eye surgery in the month of March for only $2,400.
- The company records the following at the time of service:

March 1	Debit	Credit
Accounts Receivable	**2,400**	
Service Revenue		**2,400**
(Provide services of $3,000 on account for the trade discount price of $2,400)		

Sales Returns and Allowances

Customers sometimes return goods or are dissatisfied with products or services because of a deficiency

Sales Return	Sales Allowances
• Customer returns goods previously purchased (a) Seller issues a cash refund if original sale was for cash (b) Seller reduces balance of accounts receivable if original sale was on account	• Customer does NOT return goods (a) Seller issues a cash refund if original sale was for cash (b) Seller reduces balance of accounts receivable if original sale was on account

Sales Returns

- On March 2, F.Y.Eye sells sunglasses to one of its customers for $200 on account.
- On March 4, the customer decides she doesn’t want eyeglasses and receives full credit from F.Y.Eye.
- The company records the following:

March 4	Debit	Credit
Sales Returns.............................	**200**	
Accounts Receivable		**200**
(Customer return on account.)		

Sales Allowances

- The customer having laser eye surgery on March 1 for $2,400 is not completely satisfied with the outcome of the surgery.
- On March 5, F.Y.Eye allows a $400 reduction in the amount owed by the customer.
- The company records the following:

March 5	Debit	Credit
Sales Allowances	**400**	
Accounts Receivable		**400**
(Provide sales allowance for previous credit sale)		

Common Mistake

- Students sometimes misclassify contra revenue accounts—sales returns and sales allowances—as expenses.
- Like expenses, contra revenues have normal debit balances and reduce the reported amount of net income.
- However, contra revenues represent *reductions* of revenues, whereas expenses represent the separate costs of generating revenues.

Sales Discounts

- Reduction in the amount to be received from a credit customer if collection on account occurs within a specified period.
- Discount terms, such as 2/10, n/30, are a shorthand way to communicate the amount of the discount and the time period within which it's available.
  - The term "2/10," pronounced "two ten," for example, indicates the customer will receive a 2% discount if the amount owed is paid within 10 days.
  - The term "n/30," pronounced "net thirty," means that if the customer does not take the discount, full payment net of any returns or allowances is due within 30 days.

Collection During the Discount Period

- F.Y.Eye typically provides laser eye surgery for $3,000. The company offers laser eye surgery in the month of March for only $2,400. F.Y.Eye provides laser eye surgery to a customer on March 1 for $2,400 on account with terms of 2/10, n/30.
- Cash is collected from the customer on March 10, which is within the 10-day discount period.
- The company records the following:

March 10	Debit	Credit
Cash	**1,960**	
Sales Discounts	**40**	
Accounts Receivable		**2,000**
(Collect cash on account with a 2% sales discount)		

Illustration 5–1

Income Statement Reporting Revenues Net of Sales Returns, Allowances, and Discounts

F.Y.EYE
Income Statement (partial)

Service revenue	$2,400
Sales revenue	200
Less: Sales returns	(200)
Less: Sales allowances	(400)
Less: Sales discounts	(40)
Net revenues	**$1,960**

$3,000 less $600 trade discount

Illustration 5–2

Balance of Accounts Receivable after Credit Sales, Sales Return, Sales Allowance, and Collection on Account after Sales Discount

	Accounts Receivable				
Credit sale $2,400 after $600 trade discount	Mar. 1	2,400	Mar. 4	200	Sales return of $200
Credit sale of $200	Mar. 2	200	Mar. 5	400	Sales allowance of $400
			Mar. 10	2,000	Cash collection of $1,960 with $40 sales discount
Ending balance	Bal.	0			

Collection After the Discount Period

- F.Y.Eye typically provides laser eye surgery for $3,000. The company offers laser eye surgery in the month of March for only $2,400. F.Y.Eye provides laser eye surgery to a customer on March 1 for $2,400 on account with terms of 2/10, n/30.
- Cash is collected from the customer on March 31, which is *not* within the 10-day discount period.
- The company records the following:

March 10	Debit	Credit
Cash	**2,000**	
Accounts Receivable		**2,000**
(Collect cash on account)		

Key Point

- Revenues are reported for the amount the company is entitled to receive.
- This amount equals total revenues minus trade discounts, sales returns, sales allowances, and sales discounts.
- Trade discounts reduce revenue directly, while sales returns, sales allowances, and sales discounts are recorded in separate contra revenue accounts and subtracted when calculating net revenues.

End-of-Period Adjustment For Contra Revenues

- The previous discussion deals with how companies record contra revenues—sales returns, sales allowances, and sales discounts—*during the year*.
- However, companies also must adjust for these amounts at the *end of the year* using adjusting entries.
- The revenue recognition standard requires a company to **report revenues equal to the amount of cash the company "expects to be entitled to receive."**

Concept Check 5–2

The effect of a sales allowance will result in which of the following:

a. An increase to net income
b. A decrease to net income
c. An increase to accounts receivable
d. An increase to sales revenue

The effect of a sales allowance is to decrease net income. A sales allowance decreases sales revenue in the income statement. A sales allowance also decreases assets by decreasing the balance of accounts receivable.

Concept Check 5–3

Which of the following computations would be used to compute Net Revenues?

a. Total Revenue + Accounts Receivable – Sales Allowances – Sales Discounts

b. Net Revenue – Sales Returns – Sales Allowances – Sales Discounts

c. Total Revenue – Sales Allowances – Sales Discounts

d. Net Income – Change in Accounts Receivable

Net Revenues is equal to Total Revenue less Sales Returns, Sales Allowances, and Sales Discounts.

PART B

ESTIMATING UNCOLLECTIBLE ACCOUNTS

Learning Objective 3

LO5–3 Establish an allowance for uncollectible accounts.

Key Point

Customers' accounts receivable we no longer expect to collect are referred to as *uncollectible accounts*, or *bad debts*.

Allowance Method (GAAP)

- Generally accepted accounting principles (GAAP) require that we account for **uncollectible accounts** using the **allowance method**.
- Companies must:
  - Estimate the amount of current accounts receivable that will prove to be uncollectible in the future.
  - Report this estimate as a contra asset to its accounts receivable.
- Under the allowance method, companies are required to estimate *future* uncollectible accounts and report those estimates in the *current* year.

Key Point

- Under the allowance method, accounts receivable are reported for the net amount expected to be collected.
- At the end of the current year, estimated future uncollectible accounts are reported in a contra asset account, reducing net accounts receivable.

Applying the Allowance Method

1. At the end of the initial year, establish an allowance by estimating future uncollectible accounts
2. During the subsequent year, write off actual bad debts as uncollectible
   - Note that *actual* write-offs may differ from the previous year's *estimate*.
3. At the end of the subsequent year, once again estimate future uncollectible accounts.

Estimating Uncollectible Accounts

- At the end of 2024, Kimzey is owed $20 million from customers and estimates that 30% will not be collected.
- The company records the following:

December 31, 2024 ($ in millions)	Debit	Credit
Bad Debt Expense	**6**	
Allowance for Uncollectible Accounts...		**6**
(Estimate future bad debts)		
($20 million × 30% = $6 million)		

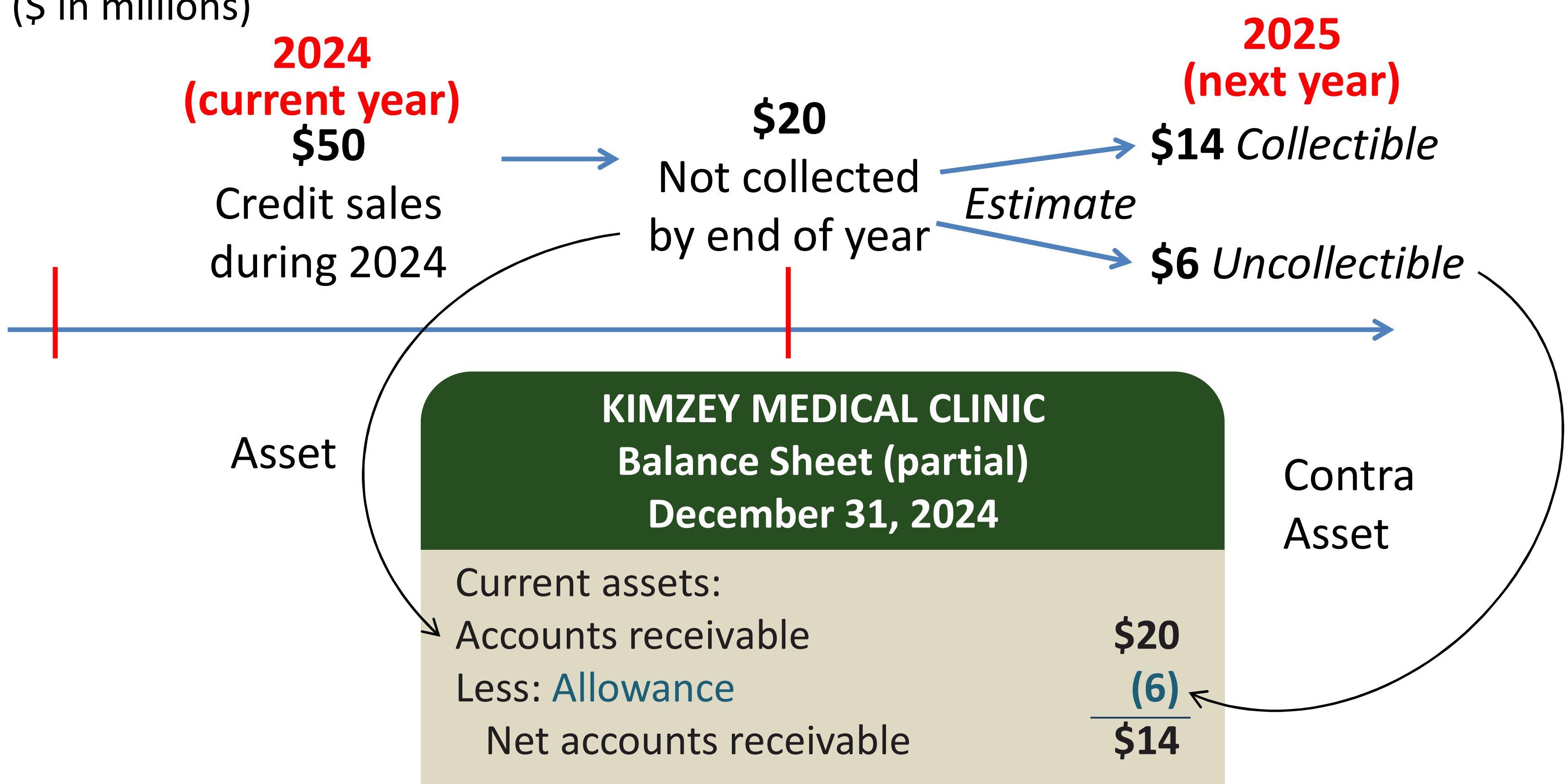
Allowance for Uncollectible Accounts

- Companies report their estimate of future bad debts using an **allowance for uncollectible accounts**.
  - Allowance for Uncollectible Accounts is a contra asset account that represents the amount of accounts receivable not expected to be collected.
- **We report the allowance for uncollectible accounts in the asset section of the balance sheet, but it represents a reduction in the balance of accounts receivable.**
  - The difference between total accounts receivable and the allowance for uncollectible accounts equals **net accounts receivable**.

Illustration 5–4

Accounting for Uncollectible Accounts and the Accounts Receivable Portion of the Balance Sheet

($ in millions)



KIMZEY MEDICAL CLINIC
Balance Sheet (partial)
December 31, 2024

Current assets:	
Accounts receivable	**$20**
Less: Allowance	**(6)**
Net accounts receivable	**$14**

Common Mistake

- Because Allowance for Uncollectible Accounts has a normal credit balance, students sometimes misclassify this account as a liability, which also has a normal credit balance.
- Instead, a contra asset represents a reduction in a related asset.

Illustration 5–5

Income Statement Showing Estimated Bad Debt Expense

KIMZEY MEDICAL CLINIC Income Statement For the year ended 2024		
($ in millions)		
Revenue from credit sales		$50
Expenses:		
Bad debt expense	$ 6	
Other operating expenses	34	40
Net Income		$10

Key Point

- Establishing an allowance for uncollectible accounts correctly reports accounts receivable in the balance sheet at the amount expected to be collected.
- Bad debt expense is reported in the income statement.

Concept Check 5–4

Which of the following is true regarding Allowance for Uncollectible Accounts?

a. It is a liability account.

b. It is added to the total of Sales Discounts, Sales Returns, and Sales Allowances.

c. It is subtracted from the balance of Accounts Receivable in the balance sheet.

d. It appears in the income statement as an expense.

The allowance account is a contra asset and is used to record estimated future uncollectible accounts. The balance is subtracted from Accounts Receivable in the balance sheet to arrive at Accounts Receivable’s carrying value.

Learning Objective 4

LO5–4 Write off accounts receivable as uncollectible.

Example of Writing Off Accounts Receivable

- On February 23, based on information about a former patient, Kimzey believes it is unlikely the patient will pay his account of $4,000.
- The company will adjust the allowance and reduce the accounts receivable balance itself as follows:

February 23, 2025	Debit	Credit
Allowance for Uncollectible Accounts …	**4,000**	
Accounts Receivable ……………………….		**4,000**
(Write off a customer's account)		

Overall, the write-off of the account receivable has no effect on total amounts reported in the balance sheet or in the income statement.

Writing Off Accounts Receivable

- When it becomes clear a customer will not pay, the company writes off the customer's account balance as uncollectible.
- The **write-off**:
  - Reduces the balance of Accounts Receivable.
  - Reduces the balance of the contra account Allowance for Uncollectible Accounts.
- The write-off has **no effect on total assets** (balance sheet) or total expenses (income statement).

Common Mistake

- Students often mistakenly record bad debt expense when they write off an uncollectible account.
- The bad debt expense was recorded in a prior year at the time of estimating uncollectible accounts.

Key Point

- Writing off a customer’s account as uncollectible reduces the balance of accounts receivable but also reduces the contra asset—allowance for uncollectible accounts.
- The net effect is that there is no change in the net receivable (accounts receivable less the allowance) or in total assets.

Collecting on Accounts Previously Written Off

- Later in 2025, on September 8, Kimzey receives a payment from the customer whose account had been written off of $1,000.
- The company records the collection using two entries:

September 8, 2025	Debit	Credit
Accounts Receivable	**1,000**	
Allowance for Uncollectible Accounts...		**1,000**
(Reestablish portion of account previously written off)		
Cash	**1,000**	
Accounts Receivable		**1,000**
(Collect cash on account)		

Concept Check 5–6

When writing off an uncollectible account:

a. Bad debt expense is debited.

b. Net income is decreased.

c. Total assets are unchanged.

d. The allowance account is credited.

The write-off of an account receivable has no effect on total amounts reported in the balance sheet or in the income statement. There is no decrease in total assets and no decrease in net income.

Learning Objective 5

LO5–5 Adjust the allowance for uncollectible accounts in subsequent years.

Adjusting the Allowance in Subsequent Years

- At the end of 2025, Kimzey Medical Clinic must once again prepare financial statements.
  - Suppose that Kimzey has credit sales of $80 million in 2025 and has year-end accounts receivable of $30 million.
  - What portion of the $30 million in accounts receivable does Kimzey not expect to collect?
- Kimzey is required to report that estimate in Allowance for Uncollectible Accounts in its year-end balance sheet as a contra asset to accounts receivable.

Percentage-of-Receivables Method

- The **percentage-of-receivables method** is a method of estimating uncollectible accounts based on the percentage of accounts receivable expected not to be collected.
- This method sometimes is referred to as a balance sheet method because we base the estimate of bad debts on a balance sheet account—accounts receivable.
- For this method, the percentage may be estimated using current economic conditions, company history, and industry guidelines.

Aging Method

- The aging method bases the estimate of future bad debts on the various ages of individual accounts receivable, using a higher percentage for “old” accounts than for “new” accounts.
  - **The older the account, the less likely it is to be collected.**
- The journal entry to estimate future bad debts is *identical* to the journal entry made using a single estimated percentage.

Key Point

- Using the aging method to estimate uncollectible accounts is more accurate than applying a single percentage to all accounts receivable.
- The aging method recognizes that the longer accounts are past due, the less likely they are to be collected.

Illustration 5–6
Kimzey's Accounts Receivable Aging Schedule

Patients	Not Yet Due	Days Past Due 1–60	Days Past Due 61–120	Days Past Due More than 120	Total
Shirley Akin	$ 12,000				$ 12,000
Cara Lott				$ 4,000	4,000
Ben Greene		$ 5,000			5,000
Anita Hand			$ 7,000		7,000
Ima Hertz	9,000				9,000
Noah Luck		8,000			8,000
Phil Sikley	6,000				6,000
Justin Payne				10,000	10,000
Others	15,973,000	8,987,000	3,993,000	986,000	29,939,000
Total Accounts Receivable	$16,000,000	$ 9,000,000	$ 4,000,000	$1,000,000	$30,000,000
Estimated Percent Uncollectible	10%	30%	50%	70%	
Estimated Amount Uncollectible	**$ 1,600,000**	**$2,700,000**	**$2,000,000**	**$ 700,000**	**$ 7,000,000**

% increases with age

Total estimated uncollectible

Using the Aging Method to Adjust the Allowance in Subsequent Years

- If the estimated amount uncollectible is $7 million, then Allowance for Uncollectible Accounts needs to have an ending balance of $7 million.
- We need to:
  1) Know the current balance of Allowance for Uncollectible Accounts and then
  2) Determine the adjustment needed so that the ending balance will be $7 million.

Illustration 5–7

Balance of Kimzey's Allowance for Uncollectible Accounts

Allowance for Uncollectible Accounts
($ in millions)

Write-offs in 2025		6	**Beg. balance for 2025**
	4		
		2	**Bal. before adjustment**
		?	**Year-end adjustment**
		7	**Ending balance for 2025**

December 31, 2025 ($ in millions)	Debit	Credit
Bad Debt Expense	**5**	
Allowance for Uncollectible Accounts...		**5**
(Estimate future bad debts)		

Illustration 5–8

Accounts Receivable Portion of the Balance Sheet

KIMZEY MEDICAL CLINIC
Balance Sheet (partial)
December 31, 2025

Assets		
($ in millions)		
Current assets:		
Accounts receivable	$30	
Less: **Allowance for uncollectible accounts**	**(7)**	
Net accounts receivable		$23

Illustration 5–9

Bad Debt Expense in the Income Statement

KIMZEY MEDICAL CLINIC Income Statement For the year ended 2025		
($ in millions)		
Revenue from credit sales		**$80**
Expenses:		
Bad debt expense	**$ 5**	
Other operating expenses	50	55
Net income		$25

Key Point

- The year-end adjusting entry for future uncollectible accounts is affected by the current balance of Allowance for Uncollectible Accounts before adjustment.
- The current balance before adjustment equals the balance of the allowance account at the beginning of the current year (or end of last year) less actual write-offs in the current year.

Concept Check 5–7

Which of the following is true about the aging method?

a. No estimate for uncollectible accounts needs to be made.

b. Older accounts are more likely to be collected.

c. It is not acceptable for GAAP.

d. Older accounts are less likely to be collected.

The aging method recognizes that the longer accounts are past due, the less likely they are to be collected. The aging method should provide a more accurate estimate of total uncollectible accounts compared to using a single percentage.

Understanding the Balance of Allowance for Uncollectible Accounts– Credit Balance Before Adjustment

Allowance for Uncollectible Accounts
($ in millions)

		6	**Beg. balance for 2025**
Write-offs in 2025	4		
		2	**Bal. before adjustment**
		?	**Year-end adjustment**
		7	**Ending balance for 2025**

Credit here indicates that the balance of the allowance account at the beginning of the year (or end of last year) may have been **too high**.

Understanding the Balance of Allowance for Uncollectible Accounts– Debit Balance Before Adjustment

Allowance for Uncollectible Accounts
($ in millions)

	Debit	Credit	
		6	**Beg. balance**
Write-offs	8		
	2		**Bal. before adjustment**
	?		**Year-end adjustment**
		7	**Ending balance**

Debit here indicates that the balance of the allowance account at the beginning of the year (or end of last year) may have been **too low**.

Illustration 5-10
Excerpt from Tenet Healthcare Corporation's Annual Report

TENET HEALTHCARE CORPORATION
Notes to the Financial Statements (excerpt)

The preparation of financial statements, in conformity with accounting principles generally accepted in the United States of America ("GAAP"), requires us to make estimates and assumptions that affect the amounts reported in our Consolidated Financial Statements and these accompanying notes. We regularly evaluate the accounting policies and estimates we use. In general, we base the estimates on historical experience and on assumptions that we believe to be reasonable given the particular circumstances in which we operate. Although we believe all adjustments considered necessary for a fair presentation have been included, actual results may vary from those estimates.

Illustration 5-11

Excerpt from Tenet Healthcare Corporation's Annual Report

TENET HEALTHCARE CORPORATION
Notes to the Financial Statements (excerpt)

Age	Medicare	Medicaid	Managed Care	Indemnity, Self-Pay, and Other	Total
0–60 days	$172	$34	$906	$126	$1,238
61–120 days	9	14	259	84	366
120–180 days	4	7	162	60	233
Over 181 days	4	14	291	330	639
Total	$189	$69	$1,618	$600	$2,476

Subsidiary Ledgers

- A subsidiary ledger contains a group of individual accounts associated with a particular general ledger control account.
  - For example, the subsidiary ledger for accounts receivable keeps track of all increases and decreases to individual customers' accounts.
- The balances of all individual accounts then sum to the balance of total accounts receivable in the general ledger and reported in the balance sheet.

Concept Check 5–8

On December 31 before adjusting entries, a company's balance of Allowance for Uncollectible Accounts is a credit of $2,000. What does a "credit" balance prior to adjusting entries indicate?

a. The company did not estimate bad debts last year.

b. Last year's estimate of bad debts was too low.

c. The company's estimate equals actual bad debts.

d. Last year's estimate of bad debts was too high.

The Allowance for Uncollectible Accounts is a contra account with a credit balance. The balance is reduced (debited) for actual bad debts. If the account balance at the end of the year is a credit, then estimated bad debts for this year are greater than this year's actual bad debts.

Concept Check 5–9

On December 31 before adjusting entries, a company reports the following balances:

- Accounts Receivable $100,000
- Allowance for Uncollectible Accounts $2,000 (debit)

The company estimates bad debts to be 20% of accounts receivable. The adjusting entry would include:

a. A debit to Bad Debt Expense for $22,000

b. A credit to Allow. for Uncollectible Accts for $18,000

c. A credit to Allow. for Uncollectible Accts. for $20,000

d. A debit to Bad Debt Expense for $20,000

Bad debts are estimated to be $20,000 (= $100,000 × 20%). The current $2,000 debit balance of the Allowance needs a credit adjustment of $22,000 to be equal to $20,000 credit. (Debit balance of $2,000 + Credit of $22,000 = Credit balance of $20,000.) The adjustment of $122,000 is recorded as a debit to Bad Debt Expense and a credit to Allowance for Uncollectible Accounts.

Learning Objective 6

LO5–6 Contrast the allowance method and direct write-off method when accounting for uncollectible accounts.

Direct Write-Off Method (Not GAAP)

- For tax reporting, companies use an alternative method commonly referred to as the direct write-off method.
- Under this method, bad debts are written off only at the time they actually become uncollectible.
  - Unlike the allowance method, which requires estimation of uncollectible accounts before they even occur
- the direct write-off method is generally not allowed for financial reporting under GAAP.
  - The direct write off method is only used in financial reporting if uncollectible accounts are not anticipated or are expected to be very small.

Example of Writing Off Accounts Receivable Using the Direct Write Off Method

- A company provides services on account for $100,000 in 2024, but makes no allowance for uncollectible accounts at the end of the year. Then, in the following year on September 17, 2025, an account of $2,000 becomes uncollectible.
- The company records the actual write-off as follows.

September 17, 2025	Debit	Credit
Allowance for Uncollectible Accounts …	**2,000**	
Accounts Receivable ………………………		**2,000**
(Write off a customer's account directly)		

Illustration 5–12

Comparing the Allowance Method and the Direct Write-off Method for Recording Uncollectible Accounts

2024	Allowance Method			Direct Write-off Method		
Year-end Adjustment (Estimate = $2,000)	**Bad Debt Expense**	**2,000**		No adjustment		
	Allowance for Uncollectible Accounts		2,000			
2025						
Actual Write-offs (Actual = $2,000)	Allowance for Uncollectible Accounts	2,000		**Bad Debt Expense**	**2,000**	
	Accounts Receivable		**2,000**	**Accounts Receivable**		**2,000**

The difference between the two methods is in the timing.

Common Mistake

- Some students erroneously think firms should reduce total assets and record bad debt expense at the time the bad debt actually occurs.
- However, companies ***anticipate*** future bad debts and establish an allowance for those estimates.

Key Point

- The direct write-off method waits to reduce accounts receivable and record bad debt expense until accounts receivable prove uncollectible in the future.
- This leads to accounts receivable being overstated in the current year.
- The direct write-off method generally is not acceptable for financial reporting.

PART C

NOTES RECEIVABLE AND INTEREST

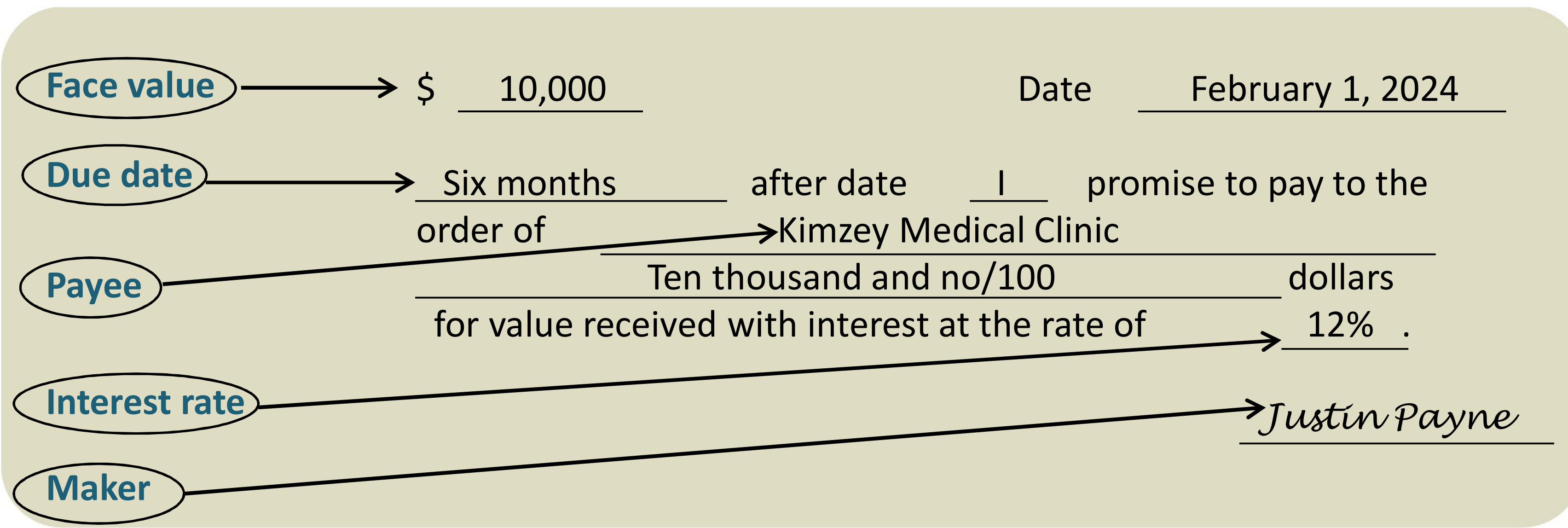
Learning Objective 7

LO5–7 Account for notes receivable and interest revenue.

Illustration 5–13

Note Receivable

- Notes receivable are assets.
- We classify notes receivable as either current or noncurrent, depending on the expected collection date.
- If the time to maturity is longer than one year, the note receivable is a long-term asset.



Recording Notes Receivable

- Kimzey provided $10,000 of services to Justin Payne, who is not able to pay immediately
- Justin Payne signs a promissory note, offering to pay $10,000 plus 12% interest in six months (August 1)

February 1, 2024	Debit	Credit
Notes Receivable ……………………………………	**10,000**	
Service Revenue ………………………………		**10,000**
(Accept a six-month, 12% note receivable for services provided)		

- No interest is recorded on February 1

Accepting a Note Receivable to Replace an Existing Accounts Receivable

- Over time, it became apparent that Justin would not be able to pay quickly, so Kimzey required Justin to sign a six-month, 12% promissory note on February 1, 2024.
- When Justin signs the note, Kimzey records the following transaction to reclassify the existing account receivable as a note receivable.

February 1, 2024	Debit	Credit
Notes Receivable	**10,000**	
Accounts Receivable		**10,000**
(Reclassify accounts receivable as notes receivable)		

Key Point

Notes receivable are similar to accounts receivable except that notes receivable are formal credit arrangements made with a written debt instrument, or ***note***.

Interest Calculation and Collection of Notes Receivable

- Kimzey accepted a six-month, 12% promissory note.
- The terms of the six-month note mean that Kimzey will charge Justin Payne one-half year of interest, or 6%, on the face value.
- Interest on Kimzey's note receivable is calculated as follows.

Interest	=	Face value	×	Annual interest rate	×	Fraction of the year
$600	=	$10,000	×	12%	×	6/12

Key Point

We calculate interest as the face value of the note multiplied by the stated annual interest rate multiplied by the appropriate fraction of the year that the note is outstanding.

Collection of Notes Receivable

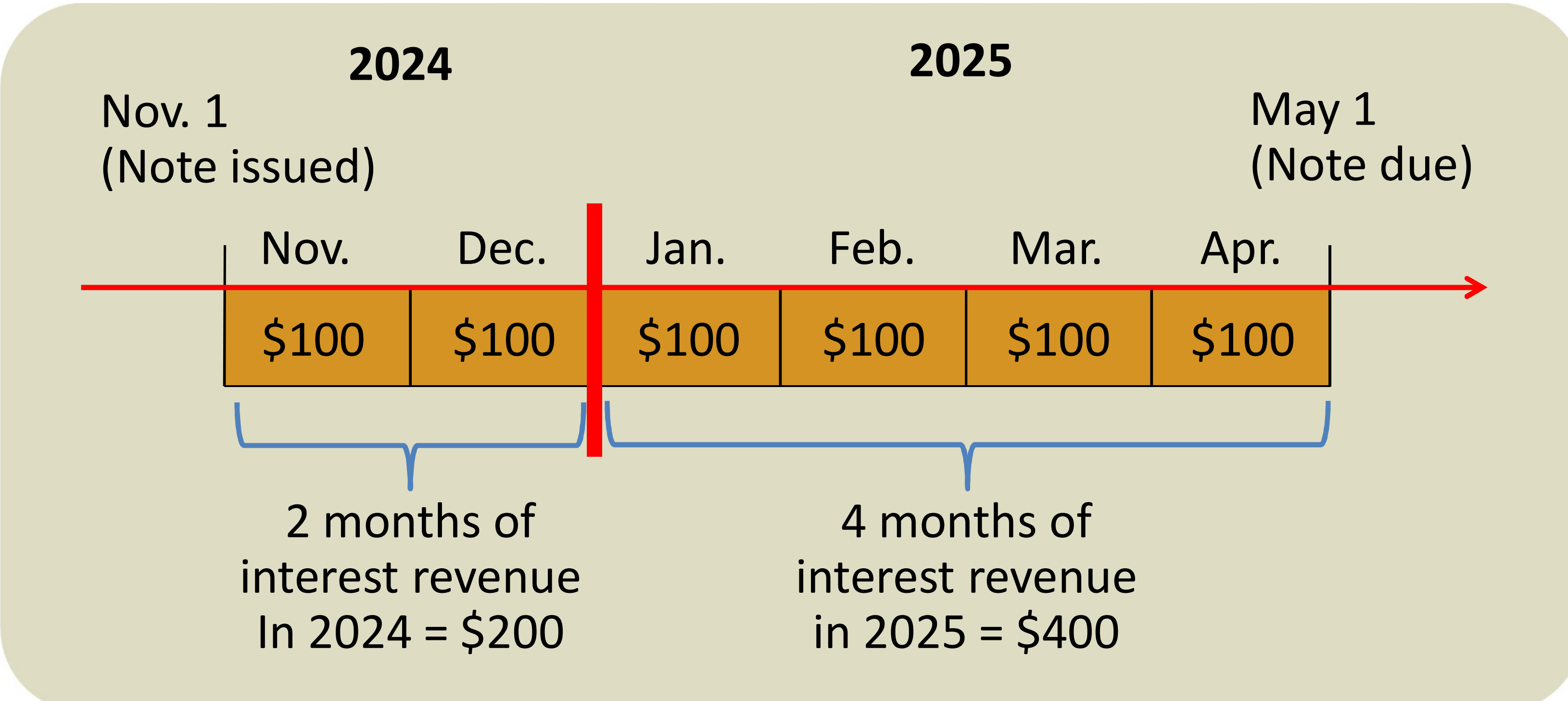
- After six months, Kimzey collects the full amount owed by Justin, **including interest.**
- Kimsey records the following entry:

August 1, 2024	Debit	Credit
Cash	**10,600**	
Notes Receivable		**10,000**
Interest Revenue		**600**
(Collect note receivable and interest)		
(Interest revenue = $10,000 × 12% × 6/12)		

Illustration 5–14

Calculating Interest Revenue over Time for Kimzey Medical Clinic

Let’s assume Justin Payne issued the previous six-month note to Kimzey on November 1, 2024, instead of February 1, 2024.



Accrue Interest

- Payne issued the a six-month note to Kimzey on November 1, 2024. The $10,000 face value (principal) and $600 interest on the six-month note are not due until May 1, 2025.
  - Because Kimzey earns two months of interest in 2024, it must accrue that interest of $200 on December 31, 2024 (even though no cash has been collected).
- The adjusting entry to accrue interest revenue follows:

December 31, 2024	Debit	Credit
Interest Receivable	**200**	
Interest Revenue		**200**
(Accrual of interest revenue = $10,000 × 12% × 2/12)		

Collect Note Receivable and Interest

- On December 31, 2024, Kimzey accrues interest for note receivable accepted on November 1, 2024.
- On May 1, 2025, the maturity date, Kimzey collects the note of $10,000 and the interest of $600.

May 1, 2025	Debit	Credit
Cash ……………………………………………….	**10,600**	
Notes Receivable …………………………….		**10,000**
Interest Receivable (from 2024) ……..		**200**
Interest Revenue (from 2025) ………..		**400**
(Collect note receivable and interest)		
(Interest revenue = $10,000 × 12% × 4/12)		

Key Point

We record interest earned on notes receivable but not yet collected by the end of the year as interest receivable and interest revenue.

Concept Check 5–10

A company accepts a note receivable of $5,000 on September 1, 2024, that matures in 10 months and has stated interest of 6%. What amount of interest revenue will the company record in 2024 and 2025?

a. 2024 = $100; 2025 = $150

b. 2024 = $125; 2025 = $125

c. 2024 = $150; 2025 = $100

d. 2024 = $0; 2025 = $250

Interest Revenue	=	Face value	×	Annual interest rate	×	Fraction of the year

2024: Interest Revenue = $5,000 × 6% × 4/12 = $100

2025: Interest Revenue = $5,000 × 6% × 6/12 = $150

ANALYSIS

RECEIVABLES ANALYSIS

Tenet vs. CVS Health

ANALYSIS - Learning Objective 8

LO5–8 Calculate key ratios investors use to monitor a company's effectiveness in managing receivables.

Receivables Turnover Ratio

Number of times during a year the average accounts receivable balance is collected

$$\text{Receivables turnover ratio} = \frac{\text{Net credit sales}}{\text{Average accounts receivable}}$$

Average Collection Period

Number of days the average accounts receivable balance is outstanding

$$\text{Average collection period} = \frac{\text{365 days}}{\text{Receivables turnover ratio}}$$

Illustration 5–15

Comparison of Receivables Ratios between Tenet Healthcare and CVS Health

	Receivables Turnover Ratio	Average Collection Period
Tenet Healthcare	$18,479 ÷ **$2,669** = 6.9	365 ÷ 6.9 = 52.9
CVS Health	$256,776 ÷ **$18,624** = 13.8	365 ÷ 13.8 = 26.4

- Tenet:
  - Higher receivables turnover
  - Shorter collection period
  - More efficiently collects cash from patients

Key Point

The receivables turnover ratio and average collection period can provide an indication of management's ability to collect cash from customers in a timely manner.

Concept Check 5–11

Which of the following would be true for a company that has an accounts receivable turnover of 10?

a. The company turns over their accounts receivable more than once a month.

b. The company would have an average collection period of 36.5 days.

c. The company would be considered as doing an efficient job of collecting receivables if the terms were net 30.

d. The company would have an average collection period of 20 days.

The average collection period is computed as 365 divided by the accounts receivable turnover of 10 (= 36.5 days).

APPENDIX

PERCENTAGE-OF-CREDIT-SALES METHOD

APPENDIX - Learning Objective 9

LO5–9 Estimate uncollectible accounts using the percentage-of-credit-sales method.

Percentage-of-Credit-Sales Method

- we can estimate uncollectible accounts using an income statement account—credit sales.
- Estimating uncollectible accounts using a percentage of credit sales is aptly referred to as the **percentage-of-credit-sales method**.

Illustration 5–16

Adjusting for Estimates of Uncollectible Accounts

Percentage-of-Receivables Method

Estimate of Uncollectible Accounts

- 20% of Accounts Receivable at the end of 2025 will not be collected.
- 20% of $30 million = $6 million.
- Adjust Allowance account from $2 million existing balance to estimate of $6 million

Adjusting Entry ($ in millions)

Bad Debt Expense	4	
Allowance for Uncoll. Accts.		4

Percentage-of-Credit Sales Method

Estimate of Uncollectible Accounts

- 10.0% of credit sales in 2025 year will not be collected.
- 10.0% of $80 million = $8 million.
- Ignore $2 million existing balance of Allowance account and add $8 million.

Adjusting Entry ($ in millions)

Bad Debt Expense	8	
Allowance for Uncoll. Accts.		8

Illustration 5–17

Financial Statement Effects of Estimating Uncollectible Accounts

Percentage-of-Receivables Method ($ in millions)		**Percentage-of-Credit-Sales Method** ($ in millions)	
Income Statement Effect		Income Statement Effect	
Revenues	$80	Revenues	$80
Bad debt expense	(4)	Bad debt expense	(8)
Net income	$76	Net income	$72
Balance Sheet Effect		Balance Sheet Effect	
Accounts receivable	$30	Accounts receivable	$30
Less: Allowance	(6)*	Less: Allowance	(10)*
Net accounts receivable	$24	Net accounts receivable	$20
*$6 = $2 + $4 (adjustment)		*$10 = $2 + $8 (adjustment)	

Key Point

When applying the percentage-of-credit-sales method, we adjust the allowance for uncollectible accounts for the current year's credit sales that we don't expect to collect (rather than adjusting at the end of the year for the percentage of accounts receivable we don't expect to collect).

Concept Check 5–12

On December 31 before adjusting entries, a company reports the following balances:

Accounts Receivable	$100,000
Allowance for Uncoll. Accts.	$2,000 (credit)
Credit Sales	$500,000

The company estimates bad debts to be 4% of credit sales. The adjusting entry would include:

a. A debit to Bad Debt Expense = $18,000

b. A credit to Allowance for Uncoll. Accts. = $24,000

c. A credit to Allowance for Uncoll. Accts. = $22,000

d. A debit to Bad Debt Expense = $20,000

The adjustment equals $500,000 × 4% = $20,000. The adjusting entry includes a debit to Bad Debt Expense and a credit to Allowance for Uncollectible Accounts.

End of Chapter 5