1 Revenue Recognition; Allowance Accounting

Old Revenue Recognition Principles

Earnings = Revenues – Expenses
Old Revenue Recognition Intuition:

- **Earned** Earnings process substantially complete

- **Collectible** Cash collection reasonably assured

Expenses matched to revenues by matching principle

Bad Debts

Two ways of accounting for bad debts:

- the direct method: required for income taxes. cons:

  - Improper matching of expenses to revenues

  - More reliable info but less relevant (i.e. less timely)

- the allowance method: two methods

  - percentage of sales

  - aging method.

  A/R (net) = A/R (gross) – Allowance for doubtful accounts (ADA) A/R (net) = A/R (gross) - ending ADA

The BASE equation

Beginning balance
+ **A**dditions
- **S**ubstractions
= **E**nding Balance
Example:

Beginning balance (e.g. ADA - allowance for doutful accounts)
+ **A**dditions (e.g. bad debt expense a.k.a. provision charged to income statement)
- **S**ubstractions (e.g. write-offs a.k.a. amount deemed uncollectible)
= **E**nding Balance
Beginning ADA + Bad Debt Expense – Amounts Written Off = Ending ADA

Allowance Method 2: Aging Method

Ratios Involving Receivables

A/R Turnover = Revenue / Average Accounts Receivable (net)
Days receivables = (1 / A/R Turnover) * 365

Liability for Return Allowances

Allowances for product returns are very similar to the Allowance for Doubtful Accounts, except that Allowances for product returns are a liability, whereas Allowance for Doubtful Accounts is a contra-asset.

Key Terms and Usage

- **A/R**: Acconts Receivable.

  - Customer purchases' made on account (i.e. you will receive a payment later

  - I/S: Revenue is recognized when earned, not received

  - B/S: Asset account impacted

- **ADA**: Allowance for doubtful accounts

  - Company provisions for uncollectible A/R

  - I/S: Depends on how it changes

  - B/S: Contra-asset account impacted

- **BDE**: Bad debt expense

  - Future projections for uncollectible A/R

  - I/S: Expense recognized as % of sales

  - B/S: Increase ADA account by same amount

- **Write-off**

  - A/R that "goes bad" in that time period (i.e. it becomes clear that the customer cannot pay)

  - I/S: No impact

  - B/S: Reduce ADA and A/R