Chapter 7 – Accounting for Receivables
MGMT 1A

I. Current Assets = CnAMPs

C ash

N otes Receivable ← similar A/R, more liquid, not exchanged for goods (services) loan.

A ccounts Receivable. ←

M erchandise Inventory

P repaid Expenses

S upplies.

II. GAAP = The collection of rules we follow in accounting:

G enerally A ccepted A ccounting P rinciples.

III. Accounts Receivable – Bad Debts

A. Management's Concerns – Goldilocks Principle.

Too much A/R: $\boxed{\text{Extending too much credit}}$

Too little A/R: Not willing to extend credit.

IV. $\boxed{\text{Bad Debts}}$ – Sometimes a customer won't pay up

A. Direct Write-Off Method – Record the expense when we write off the receivable

1. Example: During December, we sell goods costing $50,000 on account for $100,000:

12/31 A/R $100,000

Sales $100,000

COGS $50,000

Merch. Inv. $50,000

(To record of sale of goods on account)

On 2/1, one Customer calls and says, "I can't pay $10,000.":

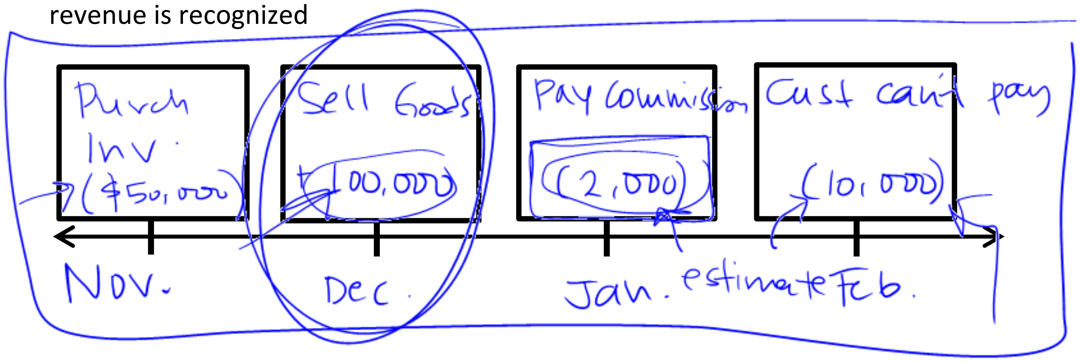
2/12 Bad Debt $\boxed{\text{Expense}}$ $10,000

A/R $10,000

2. Why is Direct Write-Off Bad? Because it is not GAAP
    a. Violates the Matching Principle
        i. Costs incurred to generate revenues should be expensed in the same period the revenue is recognized

Estimated Bad Debt 12/Y1

        ii.



Y1 Y2

-50
+100
-2
-10
+38

    b. Violates Conservatism. Principle – Do not overstate assets and income

100,000
Y1: A/R = $ 90,000 ← ? Sales 100
Y2: A/R = ($10,000) Exp (10)

    c. When is Direct Write-Off used? Tax Basis. (taxes = nearly cash. taxable. A/R collectible)

B. Allowance Method (GAAP) – Record expense in the period of sale
    1. Adjusting entry is made at the end of the year

A: 12/31/Y1 Bad Debt Expense $15,000
"Allowance" for Bad Debts $15,000
[generic, unassigned]
↑ Contra-Asset (reduces A/R)

aka: Allowance for Doubtful Accounts

Historical data: "good faith" it's ok.

2. Balance Sheet Presentation:

PPE

Accounts Receivable	$ 100,000
Less: Allow for DA	(15,000)
A/R, net	85,000

(Less A/D)
Book Value

Net Realizable Value.

3. On 2/16/Y2 Customer A calls and cannot pay invoice of $2,000. What is the entry to write off the account?

2/16/Y2 Allow for Bad Debts $2,000
A/R - Cust. A $2,000
(To write off cust A receivable)

A/R	
100,000	2,000
98,000	

Allowance	← generic.
2,000	15,000
	13,000

4. Balance Sheet Presentation: 2/16/Y2

Accounts Receivable	$98,000
Less: Allow for BD	(13,000)
A/R, net	85,000

← cash to collect.

eliminating anonymity of allow.
allocating allow to a specific customer.

5. On 7/1, Customer A calls and can pay $500. What should the Company do?

   a. Reinstate the A/R:

   1 A/R - Cust. A 500 ✱
   Allowance 500

   b. Record the payment:

   2 Cash 500
   A/R - Cust A 500 ✱

A/R - Customer

2000	
	2000
∅	
500	
	500
∅	

C. Comparison of Methods:

	Direct Write-Off Method	Allowance Method
Dec.	No entry	A:: Bad Debt Exp XX Allow. XX
Feb.	Bad Debt Exp XX A/R XX	Allow XX A/R XX
High Level:	Same PR/CR	Same PR/CR
Timing:	Exp. Y2	Exp. Y1 ✱ Matching ✱

Two Key Takeaways:

1. In the long run – Both do the same thing
2. In the short run – Exp. reflected in different periods.

Yes, but ignores timing

D. Estimating Bad Debts

OK — 1. Income Statement Approach: % of Sales Method – is it GAAP?

1/1 3/31 12/30

Expense

Timing of sales

a. Example: Credit Sales for the year = \$1M. We estimate that 1% will go bad. (= \$10,000)

Beginning balance in the Allowance = \$600. What is the adjusting entry to record?

i. How much ~~more~~ allowance do we need? → beg. bal. irrelevant.

A: 12/31 Bad Debt Exp. \$10,000

Allowance \$10,000

(To record bad debt expenses)

Better. 2. Balance Sheet Approach: Aging of Receivables timing focus on B/S accounts.

a. Example: Accounts receivable balance at 12/31 = \$350,000. We estimate that 3% will go bad. Beginning balance in the Allowance = \$600.

What is the adjusting entry to record?

(1M)

i. How much allowance do we need **in total**?

remaining unpaid

$\boxed{350,000} \times 3\% = \$10,500$

ii. How much **more** allowance do we need to record?

A: 12/31 Bad Debt Exp \$9,900

Allowance \$9,900

Allowance for Doubtful Accounts

	600
	$\boxed{9,900}$
	10,500

w in 60

0-30 31-60 61-90 90+

→ report

b. A/R Aging – splits the entire balance into buckets based on how old the invoices are

A/R

c. Example: Accounts receivable aging at 12/31:

	Amount	% bad debt	Allowance needed
0 – 30 days old	\$100,000	x 1%	\$1,000
31 – 60 days old	\$100,000	x 2%	\$2,000
61 – 90 days old	\$100,000	x 4%	\$4,000
91 + days old	\$ 50,000	x 10%	\$5,000
Totals	\$350,000		\$12,000

Estimate more precise

Allowance

| 600
| 11,400
| 12,000

Beginning balance in the Allowance = \$600. What is the adjusting entry to record?

A: 12/31	Bad Debt Exp	11,400	
	Allowance		11,400
	(To record Bad debt Exp.)		

1. Interest 1-3%
2. Fees

E. Credit Card Sales:
(Interesting read: http://time.com/money/4410238/pay-with-cash-value-of-money-study/)

1. Considered cash sales by the retailer — Cash (c/c) Sales

2. Fee is paid to credit card company — Service

3. Example: In N Out Burger made $10,000 Visa credit sales. Visa charges a 2% service fee. — expense

What is the entry for In N Out to record the credit card sales?

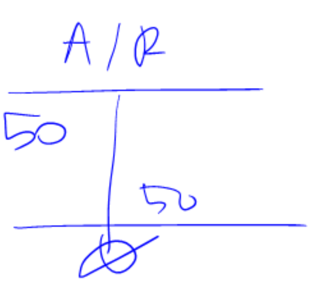
Cash $9,800
Credit Card Fee Expense $200 (2% * 10,000)
Sales $10,000

F. Factoring Receivables — Company B buy Company A A/R 60 days NOW

1. Selling receivables for a fee — NOW (85%)

2. Recourse – If the factor can't collect the receivable, they can come back to the original company and collect from them — Jon Smith. — Comp B.

w/
w/o
Riskier
Fee ↑ w/o



3. Example: Revlon factors $50,000 of its receivables to Max Factoring Company **without recourse**. Max charges a 30% service charge. What is the entry for Revlon to record?

✓ Cash $35,000 (50,000 * (1 - 30%))
* Loss on Sale $15,000 ← Factoring fee
A/R $50,000

V. Financial Analysis → fairly meaningless unless compared → PYs → Competitor → market

A. Accounting Receivable Turnover – How many times per year a company collects its receivables

$$\frac{\text{Net Credit Sales} \leftarrow 1 \text{ year}}{\text{"Average" net A/R}}$$

point in time

		Y2	Y1
Office Depot	A/R, net	end 931	beg 687
	Sales	10,240	11,021
Staples	A/R, net	1,538	1,543
	Sales	18,247	18,764

$$\frac{Y2+Y1}{2}$$

HIGH

Efficient

1. Calculate A/R Turnover for Office Depot Y2

$$\frac{10,240}{[(687+931)/2]} = 12.66 \quad < 1x$$

2. Now Calculate A/R Turnover for Staples. How does this compare to Office Depot?

Y2
$$\frac{18,247}{[(1543+1538)/2]} = 11.84$$

B. Days Sales Outstanding – Measures how quickly a company can convert its accounts receivable into cash.

(DSO)

$$\frac{A/R}{\text{Net Sales}} \times 365$$

A/R ⇒ Cash

LOWER

		Y3	Y2	Y1
Home Depot	A/R	1,952	2,029	1,890
	Net Sales	100,904	94,595	88,519

1. Calculate DSO for each year. What does it tell you?

Y3 $\frac{1,952}{100,904} \times 365 \cong$ 7 days

Y2 $\frac{2,029}{94,595} \times 365 = \sim 7.8$

Y1 $\frac{1,890}{88,519} \times 365 \cong 7.8$ days

C. Average Collection Period (in days) – Approximately how many days it takes to collect receivables similar to DSO.

$$\frac{365}{\text{AR Turnover}}$$

Average A/R

1. Calculate Average Collection Period for Office Depot and Staples

OD = $\frac{365}{12.66}$ = 28.83 day

slower

Staples $\frac{365}{11.84}$ = 30.82 days

2. One mistake:

Credit Sales

Total = cash + credit

VI. Promissory Note – A legal promise to pay

A. Stronger legal standing → court hold up better legal contract
B. It acknowledges the debt
C. It pays interest
D. Example: On 3/19, Company issues Customer a $4,000 note on account to be paid in 90 days. Bears interest at 12%.

(knuckle trick)

1. What is the maturity date? June 17
2. What is the interest on the note? (Principal x Rate x Time)

$4,000 x 12% x 90/~~365~~ 360 = $120
IA = 360 days

3. What is the journal entry for the **Company** to record at note issuance? What is the journal entry for the **Customer** (borrower) to record at note issuance?
4. What is the journal entry for the **Company** to record at note maturity? What is the journal entry for the **Customer** (borrower) to record at note maturity?

	Company (issuer)	**Customer (borrower)**
3/19	Note IR $4,000 Cash $4,000 DON'T RECORD INTEREST!!	Cash $4,000 Note P $4,000
6/17	Cash $4,120 Note IR $4,000 Other — Int. Inc. $120	Note/P $4,000 Int. Exp. $120 Other Cash $4120

P x R x T
0/360

Mirror image

Mirror images

E. Income Statement Presentation

Sales	1,000,000
COGS ①	(300,000)
Gross Profit	700,000
SG&A Expense ②	(250,000)
Operating Income	450,000
Other Income ③	500
Other Expense	(10,500)
Income before Tax	440,000
Income Taxes ④	(88,000)
Net Income	352,000

① ② ③

"multiple step" I/S

Sales
- Exp.
net Inc.