

Unit 8 Accounts Receivable

I. Credit sales are an integral part of a competitive business environment.

- A. The primary benefit of allowing credit sales is that sales will be higher.
- B. The primary cost of credit sales is that some customers will not pay (they default).
- C. Losses from defaults are charged to **bad debts expense**.

Google "Excel Internet Library" for beginning to advanced learning materials.

II. Accounting for Bad Debts

- A. The matching principal of accrual accounting requires that bad debt expense be recorded in the year of sale.
 1. Time will pass before all defaulting customers are known. This necessitates a periodic estimate of bad debts expense. **Allowance for bad debts** is charged in place of the unknown receivable.
 2. As specific defaults become known, both the accounts receivable and the allowance are lowered.
 3. Allowance for bad debts is subtracted from accounts receivable on the balance sheet.
- B. **Direct write off of receivables**
 1. Direct write off is used for cash basis accounting or when bad debt expense is immaterial.
 2. This method waits until specific defaulters are known before recording the expense.

III. Estimating Bad Debts

Google "MBA Internet Library" for help getting accepted, graduating, and getting a job.

A. Percentage of Receivable Sales

1. This method estimates bad debts based on the year's credit sales.
2. If cash sales are minimal, total sales may be used.
3. The percentage should be based on past experience and expected business conditions.
4. The allowance should approach zero as accounting for the period comes to an end.
 - a. If the balance of the allowance begins to accumulate over a number of accounting periods, bad debt estimates have been too high and should be lowered.
 - b. If a negative balance begins to accumulate, bad debt expense has been understated and should be increased.
5. Assume normal business conditions and bad debts have averaged 1.25% of credit sales for four years.
Company A credit sales were \$750,000. Bad debts expense would be estimated as follows:

$$\text{Bad Debts Expense} = .0125 \times \$750,000 = \$9,375$$

B. Percentage of current receivables

1. This method estimates bad debts based on the accounts receivable balance at the end of the period.
2. The simplest procedure uses one percentage based on experience and the current business environment.
 - a. This percentage is applied to total accounts receivable at the end of the accounting period.
 - b. This estimate becomes the new balance for allowance for bad debts.
 - c. Because a positive or negative balance may exist from previous years, the expense charged may be correspondingly lower or higher than the estimate.
 - d. Suppose the same **Company A** has a balance in the allowance for bad debts equal to \$2,000. The end of period balance of accounts receivable is \$250,000. Bad debts are estimated at 3.65% of current accounts receivable. Bad debts expense would be estimated as follows:

$$\text{Estimate} = .0365 \times \$250,000 = \$9,125$$

$$\text{Bad Debts Expense} = \$9,125 - \$2,000 = \$7,125$$

3. Aging Receivables

- a. Aging of accounts receivable is the most exact method of estimating bad debt expense because it refines the percentage taken using the age of the receivable and other information known about the debtor.
- b. Bad debts expense for **Company A** would be estimated as follows:

Time Past Due	% Uncollectible	Receivable Amount	Estimated As Uncollectible
1 - 30	3.0	\$125,000	\$3,750
31 - 60	4.0	75,000	3,000
61 - 90	4.5	40,000	1,800
Over 90	5.0	10,000	500
		Total	\$250,000
			\$9,050

$$\begin{aligned} \text{Amount to go bad} &= \$9,050 \\ \text{Bad Debts Expense is } & \$9,050 - \$2,000 = \$7,050 \end{aligned}$$

Google "Software Tutorial Internet Library" for help learning many software packages.