Accounts Receivable & Bad Debts Expense

(Cheat Sheet)

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Accounts Receivable

Accounts receivable refers to a company's unsecured claim for money it is owed by a customer or client for goods and/or services the company had provided on credit (on account).

The company that is selling the goods is usually transferring title to its goods at either:

- the time the goods are shipped (the terms are FOB shipping point), or
- the time the goods are delivered to the buyer (the terms are FOB destination)

It is at one of these points that the seller is creating an account receivable and a sale. The sales invoice will also be prepared at the same time and will result in a *debit* to Accounts Receivable and a *credit* to Sales. If a company provides services on account, it will *debit* Accounts Receivable and will *credit* Service Revenues (or Fees Earned) at the time the service has been completed.

Credit Terms

The seller's credit terms will be indicated on the sales invoice. For example, the seller may have terms of "Net 30 days" or "Due upon receipt." The term *Net* means *net sales* which is the amount of the sales invoice minus any authorized returns and/or allowances.

Early Payment Discounts

Some sellers offer an early payment discount, which allows a customer to pay less than the net amount if they pay within a stated discount period. (Early payment discounts are also referred to as *sales discounts* or *cash discounts*.)

Example 1. A seller offers an early payment discount stated as "1/10, n/30" or "1/10, net 30". This means that the customer may deduct 1% from the net amount due if the payment is made within 10 days of the date of the invoice. For instance, if a sale is made for 200 units at $15 each, the gross amount of the invoice is $3,000. If the customer is authorized to return 20 units at $15 each, the *net amount* is $2,700 and it is due in 30 days. However, the customer may deduct $27 (1% of the $2,700) if $2,673 is remitted within 10 days. Saving 1% by paying 20 days sooner (within 10 days instead of 30 days) is considered to be 18% on an annual basis. An early payment discount of "2/10, n/30" is considered to be 36% on an annual basis.

Bad Debts Expense

When sales or services are provided on credit, there is a risk that the seller will not receive the amount owed by a customer. The amount that is not collected is reported on the seller's income statement as bad debts expense. Bad debts expense is part of the selling, general and administrative (SG&A) expenses. Typically there are two methods for reporting the bad debts expense: *direct write-off method,* and *allowance method*.

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Direct Write-Off Method

Under the direct write-off method, the bad debts expense is not reported *until a specific account has been identified as uncollectible and the account is removed from the company's accounts receivable*. At that time, the company *debits* Bad Debts Expense and *credits* Accounts Receivable. The problem with the direct write-off method is that the balance sheet will report the full amount of a company's accounts receivable even though some are likely to be uncollectible. It is likely to delay reporting bad debts expense on the income statement. Hence for financial statement purposes, this is not the recommended method. (However, for U.S. income tax purposes the direct write-off method is required.)

Allowance Method

The allowance method requires a company to anticipate that some amount of the accounts receivable will not be collected. In other words, prior to writing off an account receivable, the company will debit Bad Debts Expense and will credit a contra-asset account Allowance for Doubtful Accounts for an estimated amount. The Allowance account is a contra-account to Accounts Receivable and the combined balances is referred to as the *net realizable value* of the accounts receivable. (On the balance sheet the combined amount is often presented as *accounts receivable (net)* or accounts receivable—net.)

Under the allowance method, there are two ways for anticipating and estimating the account balances for Allowance for Doubtful Accounts and for Bad Debts Expense:

- percent of accounts receivable
- percentage of credit sales

Percentage of Accounts Receivable

The percentage of accounts receivable is also known as the *balance sheet approach*, since its focus is on reporting a realistic ending balance in the balance sheet account Allowance for Doubtful Accounts. In other words, the balance in the income statement account Bad Debts Expense is secondary and will depend on the adjustment made to the Allowance account.

In order to determine the balance needed in the Allowance account, companies will review an *aging of accounts receivable*. The aging sorts the unpaid sales invoices that make up the balance in Accounts Receivable according to the invoice dates. The aging of accounts receivable will show the amounts that are current (not past due), amounts that are 1-30 days past due, 31-60 days past due, etc. A thorough review of the aging will provide insights as to the potentially uncollectible amounts needed in the Allowance account. A general rule is that the older the unpaid invoice, the more likely that the amount will not be collected in full.

Example 2. A corporation's Accounts Receivable has a debit balance of $130,000. The corporation's Allowance for Doubtful Accounts has a credit balance of $10,000. Before issuing the financial statements, an aging of accounts receivable is prepared. Based on the aging, the credit manager estimates that $18,000 of the accounts receivable will be uncollectible. Under the percentage of accounts receivable method (balance sheet approach) there needs to be a debit to Bad Debts Expense of $8,000 and a credit to Allowance for Doubtful Accounts of $8,000 (the amount needed to have a credit balance of $18,000). Hence, the balance sheet will report *Accounts Receivable – net* of $112,000 ($130,000 minus $18,000).

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Percentage of Credit Sales

The percentage of credit sales is sometimes referred to as the *income statement approach* since the focus is on the amount to be reported as bad debts expense. The objective is to match the appropriate amount of bad debts expense with the credit sales shown on the income statement. In other words, the balance in the Allowance for Doubtful Accounts is secondary and will depend on the amount of the bad debts expense.

Example 3. A corporation's Accounts Receivable has a debit balance of $130,000. The corporation's Allowance for Doubtful Accounts has a credit balance of $10,000. The corporation uses the percentage of credit sales method and estimates that 0.3% of its credit sales will not be collected. In June the credit sales are $100,000. Hence, on June 30 the corporation will prepare an entry to debit Bad Debts Expense for $300 ($100,000 X 0.3%) and will credit Allowance for Doubtful Accounts for $300 (since the objective is to have the June income statement *match $300* of Bad Debts Expense with the $100,000 of credit sales). Whatever was the beginning balance in the Allowance account is assumed to be the appropriate amount for the receivables that are unpaid from earlier periods. As a result the Allowance for Doubtful Accounts will now report a credit balance of $10,300.

Writing Off an Account When Using the Allowance Method

When the allowance method (either the percentage of receivables or the percentage of credit sales) is used and a specific account is identified as uncollectible, it is *written off* with a *debit* to Allowance for Doubtful Accounts and a *credit* to Accounts Receivable. [Note that under the allowance method, the write-off of an uncollectible account does not involve an income statement account. Both Accounts Receivable and the Allowance for Doubtful Accounts are balance sheet accounts. The bad debts expense had already been recorded as a percent of accounts receivable or as a percent of credit sales.]

Example 4. A corporation has the following account balances: Accounts Receivable debit balance of $130,000; Allowance for Doubtful Accounts credit balance of $10,000. The company has been informed that one of its customers has filed for bankruptcy and the corporation is not expecting to collect any of the $7,000 balance it is owed. Under either of the allowance methods, the corporation will write off the customer's balance with a debit of $7,000 to Allowance for Doubtful Accounts and a credit to Accounts Receivable for $7,000.

FOB Destination and FOB Shipping Point

The invoice term *FOB destination* indicates that the buyer will receive title to the goods when the goods arrive at the buyer's location. At that point the seller will have an unsecured account receivable and the buyer will have an account payable. Since the seller owns the goods while they are in transit, the seller is responsible for the goods and the cost of transporting the goods until the goods reach the buyer.

The invoice term *FOB shipping point* indicates that the buyer will receive title to the goods when the goods leave the seller's location. At that point the seller will have an unsecured account receivable and the buyer will have an account payable. Since the buyer owns the goods while they are in transit, the buyer is responsible for the goods and the cost of transporting the goods after they leave the seller's dock.

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