

Chapter 7¹

Accounting for Short-Term or Current Assets & Receivables

Learning Objectives

- Explain how a credit sale and related account receivable and payment in cash are accounted for.
- Illustrate your understanding of the 3 methods used to record accounts receivable.
- Explain which methods are GAAP and which methods are not GAAP and why.
- Describe and apply the direct write-off method.
- Describe and apply the two balance sheet-based allowance methods.
- Describe and apply the income statement-based allowance method.
- Describe a note receivable, compute its value at maturity, and account for both principal and interest components.
- Explain how a dishonored note is accounted for.
- Record dishonored receivables and their restoration and collection under all methods.
- Describe the methods used to convert receivables to cash prior to maturity.
- Compute accounts receivable turnover and explain how it is used to partially assess a firm's financial condition.
- Describe the appropriate use of the sales journal for credit sales.

¹ Acknowledgement: An earlier version of this chapter was provided to all accounting faculty on January 22, 2015, for review notes, comments, and recommendations for improvement. Work on this text began in early 2014. The completion of this text was made possible through a spring 2015 sabbatical from West Chester University.

Introductory Financial Accounting – Cataldo (WCU ACC201)

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State University - Behrend in the fall of 2013. His academic career includes 8 years at Clarion University plus another 10 years across Wayne State University, Indiana University of Pennsylvania, and Kent State University.

Prior to earning his doctorate in accounting, Professor Danvers obtained significant professional experience across manufacturing, healthcare, and Big 4 consulting. He also served as CFO for a project development / investment firm that specialized in real

estate investment. Dr. Danvers has worked extensively with financial projections, forecasts, and decision analysis applications.

Professor Danvers (standing) and consultant/friend/former classmate (seated) enjoy an afternoon of boating on the Chain O' Lakes in northeast Illinois, August, 2014.

Dr. Danvers has taught financial and managerial accounting (undergraduate and graduate), intermediate accounting, cost accounting, accounting technology, and accounting information systems. Delivery methods include traditional classroom, online, hybrid, and interactive TV.

Professor Danvers has published in several journals, including *The Journal of the American Taxation Association*, *Journal of Accounting and Public Policy*, *Research in Governmental and Nonprofit Accounting*, *The CPA Journal*, *Strategic Finance*, *Journal of Health Care Finance*, *Oil, Gas & Energy Quarterly*, and *Journal of Accounting Education*.

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- C.M.A. & C.F.M. (Institute of Management Accountants)



Accounting for Twitter, the Initial Public Offering and Capital Formation

Twitter² (NYSE: TWTR) held their IPO on November 7, 2013. More than 117 million shares traded, with an opening price of \$45.10, a high of \$50.09, a low of \$44, and a closing price of \$44.90 per share.

As summarized in the below graph, the price per share for Twitter stock rose from its high IPO price of \$50.09 per share to more than \$59 per share by December 13, 2013, only five weeks after the Twitter IPO.



² The website for Twitter is located at <https://twitter.com/>.

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A *receivable* is an amount due from some other individual or entity. Accounts receivable and notes receivable are the most common receivables, but other receivables include rents receivable and interest receivable.

A separate list of customers the firm has extended credit to is maintained, where each customer is assigned an account number (e.g., your MasterCard, VISA, or Home Depot credit cards). Some, of course, do not pay their bills, and these receivables become bad debts, an expense.

Accounts Receivable

Accounts receivable are amounts due from another, arising from a credit sale and, therefore, through the extension of credit. Receivables are classified (as current/short-term or non-current/long-term) and valued and classified on the firm's balance sheet. Current receivables are valued and reported for net realizable value, which is the amount expected to be collected and received in cash. This requires estimates of uncollectible portions (recorded in the balance sheet as contra accounts), as well as returns, allowances and discounts (recorded in the income statement as contra accounts).

Credit Sales

To record a credit sale, increase or debit *accounts receivable* and increase or credit the sales or revenues account. Assume, in the below example, that a credit sale was made for \$100.

Accounts Receivable	\$100	
Sales		\$100
To record credit sale and related receivable.		

When the \$100 accounts receivable is paid, decrease or credit accounts receivable and increase or debit cash, as follows:

Cash	\$100	
Accounts Receivable		\$100
To record collection of account receivable.		

Billing Customers for Credit Sales

Firms extending credit to their customers must maintain separate records for each customer account. They do this to track how much each customer purchased, has already paid, and still owes. This information must be maintained to bill customers. To facilitate this process, firms extending credit to their customers maintain a separate account receivable for each customer. While the general ledger maintains a single accounts receivable balance, this single master or control balance is the total of all separate accounts receivable accounts for each customer at any point in time.



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The separate accounts receivable balances for each customer or account support or supplement the balance in the general ledger. These separate supplemental accounts for each customer are called the *accounts receivable ledger*.

The Accounts Receivable Ledger

The below illustrate relations between the accounts receivable ledger, a schedule of accounts receivable and the accounts receivable balance or control total in the general ledger at any point in time. First, the accounts receivable ledger, which lists the accounts receivable balance for two customers, Customer A (with a balance of \$1,000) and Customer B (with a balance of \$2,000):

Accounts Receivable Ledger

<i>Customer A</i>			
<u>Date</u>	<u>Debit</u>	<u>Credit</u>	<u>Balance</u>
31-Dec	\$1,000		\$1,000

<i>Customer B</i>			
<u>Date</u>	<u>Debit</u>	<u>Credit</u>	<u>Balance</u>
31-Dec	\$2,000		\$2,000

If we were to prepare a schedule of all accounts receivable owed to the firm, a process that could be completed at any point in time, it would reflect the balances owed by Customer A and Customer B, as follows:

XYZ Corporation
Schedule of Accounts Receivable

<i>Customer A</i>	<i>\$1,000</i>
<i>Customer B</i>	<i>\$2,000</i>
<i>Total</i>	<i>\$3,000</i>

This same accounts receivable balance, at \$3,000, would be reflected in the general ledger control total in the general ledger for the firm, XYZ Corporation, as follows:

XYZ Corporation General Ledger
Accounts Receivable

<u>Date</u>	<u>Debit</u>	<u>Credit</u>	<u>Balance</u>
31-Dec	\$3,000		\$3,000

Of course, most firms would have many more than two customers with varying amounts of credit approvals and credit balances.

This process would be quite similar to that used for your credit card account. You have been approved, by your credit card company, for some credit card balance. They keep track of your balance and either mail or email monthly statements to you, and may even allow you to access your balance, at any time, on the Internet.

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Some customers will pay their credit sales upon receipt of the first bill, preferring to avoid paying any interest. Other customers will pay for their credit purchases over time, preferring to pay the interest or finance charges. For example, assume that customer A agreed to pay 18% interest on any unpaid balance when credit was extended. Instead of paying the entire \$1,000 balance, assume that customer A only paid \$100, as follows:

Cash	\$100
Accounts receivable	\$100

After the \$100 payment is received, customer A has a balance of \$900. If billed monthly, this balance will rise to \$913.50 ($\$900 \times 18\% \text{ per year} \div 12 \text{ months}$).

Finally, some customers will be unwilling or unable to pay off their credit purchases (or credit sales) in a timely fashion or at all.

Credit Card Sales

Merchants sign agreements with MasterCard or VISA or other credit card providers to increase sales. However, these firms, in exchange for this service, charge a merchant discount. Generally, the merchant discount ranges from 3 percent to 5 percent.

Assume customer purchases merchandise from your store for \$100, and the merchant discount is 4 percent. Your net proceeds are \$96, as follows:

Accounts receivable	\$96
Credit card expense or Merchant discount	\$4
Sales	\$100

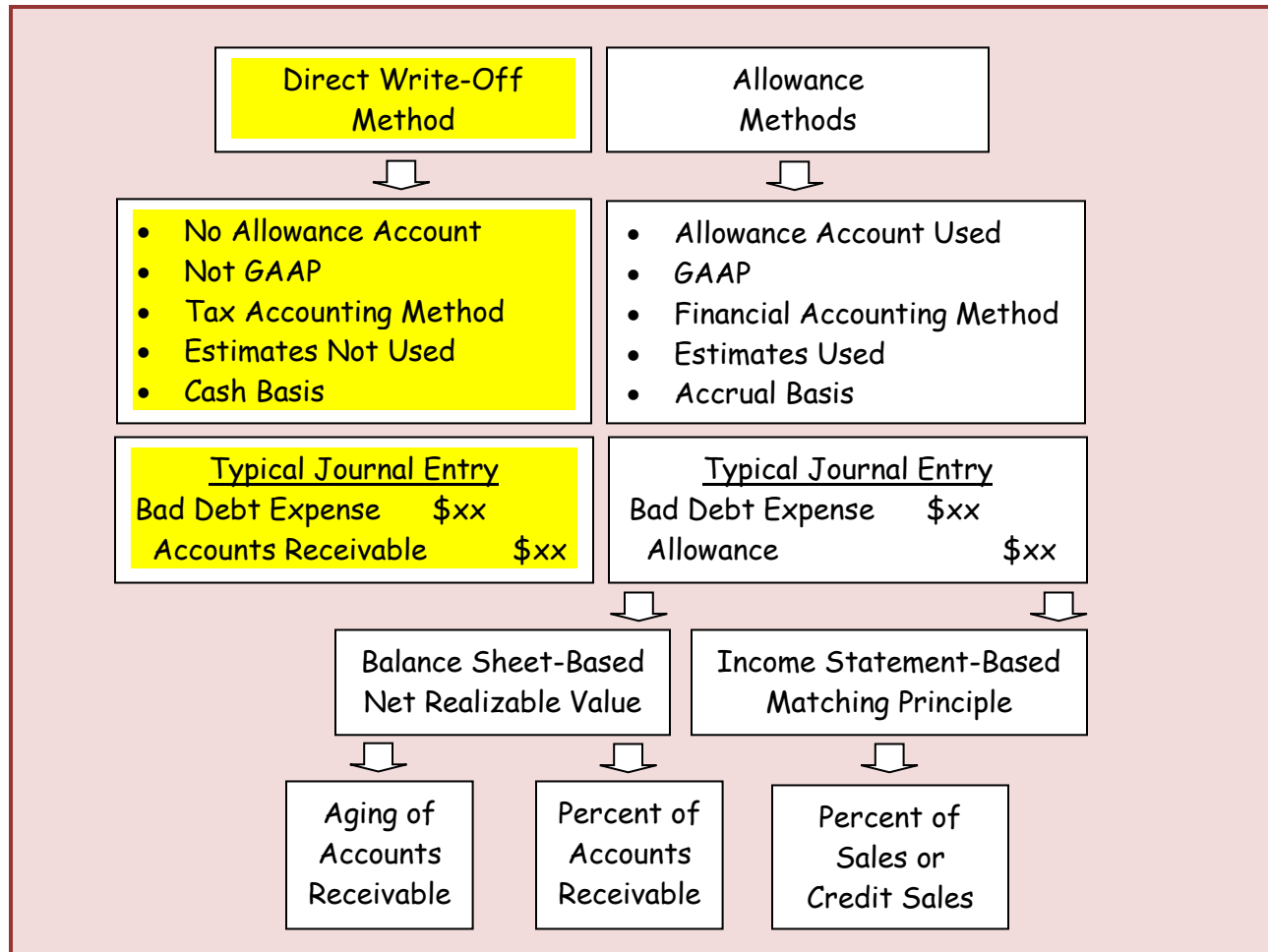
When the cash is received from the credit card company, typically through an electronic funds transfer, the following journal entry is made:

Cash	\$96
Accounts receivable	\$96

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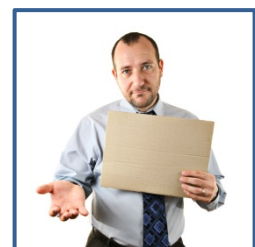
Accounts Receivable Valuation Methods

Alternative methods of accounting for trade accounting receivable are summarized in the flowchart that follows. The direct write-off method is covered, first, so this component of the flowchart is highlighted.



The Direct Write-Off Method

The direct write-off method is simple and easy to apply, but does not value and report accounts receivable at net realizable value or match revenues and expenses to the same period earned or incurred (periodicity assumption). This method does not require or use a contra asset – the allowance for doubtful accounts account. It is not-GAAP.³ This method is required by the IRS and for tax accounting purposes, even though this method is cash basis and not accrual basis. The loss is recorded with a debit to bad debt expense and a credit to the trade accounts receivable account, “writing off” the receivable “directly” to these accounts.



³ This (or any) non-GAAP method may be used if the departure from GAAP does not result in any significant or material difference. Significance or materiality is a matter of professional judgment.

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Consider the following fact pattern to illustrate weaknesses associated with use of the direct write-off method. Recall that application of the matching principle may require the use of estimates and we use accruals and contra accounts to fulfill the periodicity assumption. The direct write-off method records the bad debt expense only when the accounts receivable has been determined to be uncollectible (e.g., the firm or individual owing us the money has gone bankrupt and we have received a document confirming this fact).

A sale and account receivable for \$750 is determined to be uncollectible in April. This sale was made on credit in January, and included in January sales. No estimate of bad debts was made, since the firm uses the direct write-off method. The revenue will appear in the January income statement and

	<u>January</u>	<u>February</u>	<u>March</u>	<u>April</u>
Impact on Revenues	\$750			
Impact on Expenses				\$750

the bad debt expense will appear in the April income statement. Note how the revenues and expenses are not matched. The revenue appears in one accounting period and the related expense appears in a later accounting period, a violation of the matching principle and the periodicity assumption. The journal entry to record the bad debt, in April, follows:

Bad debt expense	\$750
Accounts receivable	\$750
To record account receivable write-off.	

If the bad debt is later recovered, simply (1) reverse the entry used to write-off the account receivable and (2) record the cash receipt, as follows:

Accounts receivable	\$750
Bad debt expense	\$750
To record recovery of account receivable previously written-off.	

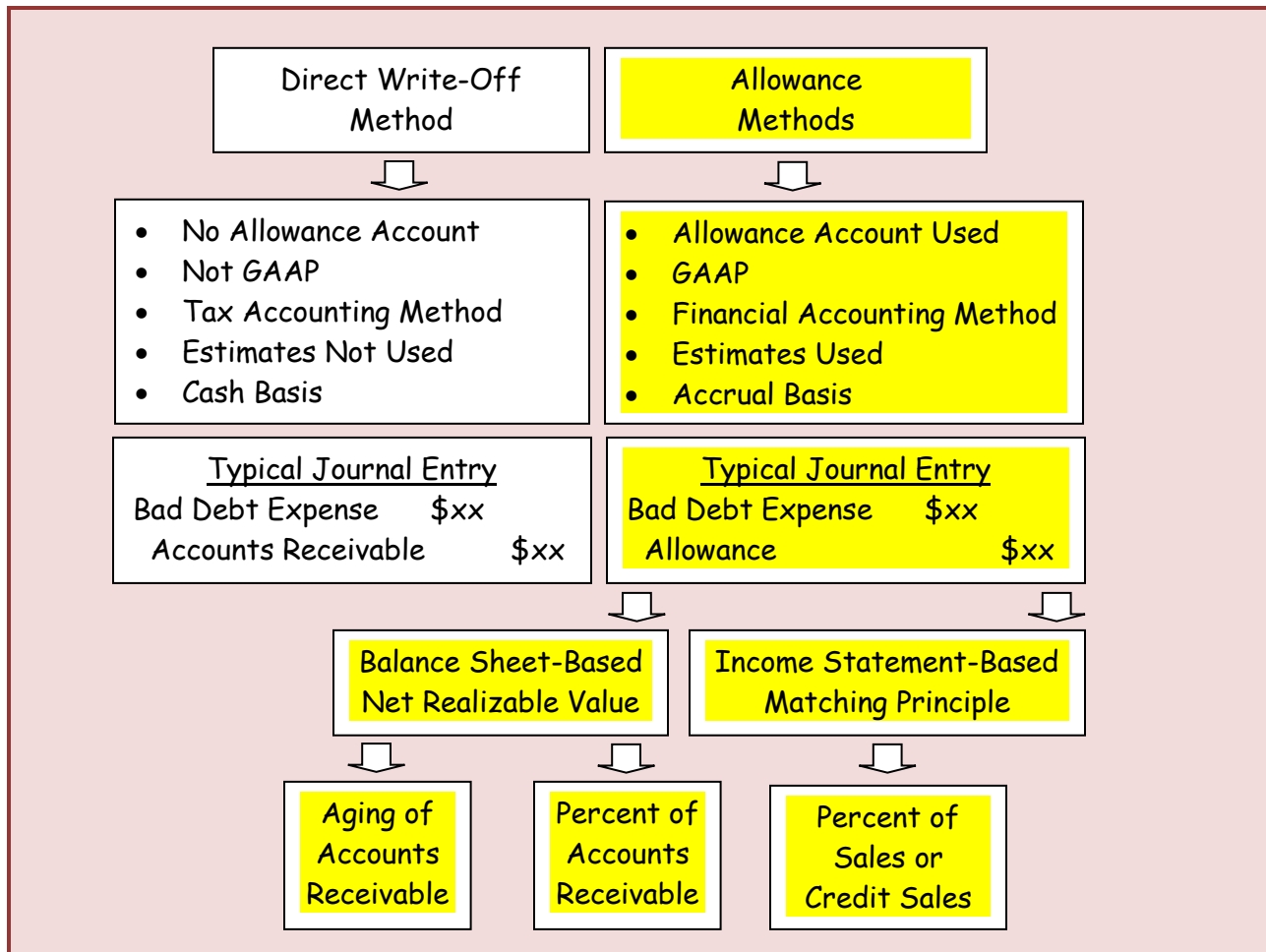
Cash	\$750
Accounts receivable	\$750
To record collection on account receivable previously written-off.	

The methods that follow are GAAP. They involve the use of systematic, rational, and methodical methods or techniques to match revenues and expenses to the appropriate accounting period, using the balance sheet for related contra asset accruals.

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Allowance Methods

Allowance methods provide for the appropriate matching of revenues and expenses to the relevant period, but require the use of estimates. A contra asset account is used to achieve this objective. This account is the allowance for doubtful accounts or allowance for uncollectible accounts. Either income statement-based and balance sheet-based approaches may be used to provide for proper matching into the relevant period. The method alternatives are highlighted in the flowchart that follows:



In all allowance method cases, there is a debit to bad debt expense and a credit to allowance for doubtful accounts, as follows:

Bad debt expense	\$xxx
Allowance for doubtful accounts	\$xxx
To record accrual for bad debts.	

In all allowance cases, when a receivable is determined to be uncollectible, the contra account, allowance for doubtful accounts, is debited and the accounts receivable account is credited.

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Using the same, \$750 example that was used to illustrate the journal entry required under the direct write-off method, the journal entry to record the write-off of an accounts receivable under an allowance method follows:

Allowance for doubtful accounts	\$750
Accounts receivable	\$750
To record write-off of account receivable.	

Again, if the bad debt is later recovered, simply (1) reverse the entry used to write-off the account receivable against allowance for doubtful accounts and (2) record the cash receipt, but as follows:

Accounts receivable	\$750
Allowance for doubtful accounts	\$750
To record collection on account receivable previously written-off.	

Cash	\$750
Accounts receivable	\$750
To record collection on account receivable previously written-off.	

A Comparison of the Direct Write-Off and Allowance Methods for a Bad Debt

The below represents a review and comparison of the journal entries use to write-off an account receivable and restore it, if it later becomes collectible, under both direct write-off and allowance methods.

<u>Direct Write-Off Method</u>		<u>Allowance Methods</u>	
No		Bad debt expense	\$xxx
Estimate		Allowance	\$xxx
The uncollectible nature of the receivable is determined			
Bad debt expense	\$750	Allowance	\$750
Accounts receivable	\$750	Accounts receivable	\$750
The account receivable is restored and collected			
Accounts receivable	\$750	Accounts receivable	\$750
Bad debt expense	\$750	Allowance	\$750
Cash	\$750	Cash	\$750
Accounts receivable	\$750	Accounts receivable	\$750

The remainder of this section of the chapter will focus on the development of the measures or amounts (\$xxx) to debit to bad debt expense and credit to allowance for doubtful accounts when establishing these accounts.

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A Single Fact Pattern

A single fact pattern will be used to illustrate all of the GAAP-based allowance methods used to establish net realizable value of accounts receivable on the firm's balance sheet and match bad debt expense to revenues and the period during which the revenues were generated. The allowance for doubtful accounts contra asset account is used to present accounts receivable at net realizable value in the balance sheet, where two balance sheet presentation examples follow:

Current assets	
Accounts receivable	\$ xx
Less allowance for doubtful accounts	(x) \$ xx

Current assets	
Accounts receivable (net of \$x doubtful accounts)	\$ xx

The next few sections will focus on 3 GAAP-based alternatives used to account for accounts receivable, allowance for doubtful accounts, and bad debt expense, using a single fact pattern, also provided below.

1. Direct write-off (non-GAAP) method
2. Allowance (GAAP) method
 - Income statement (Percentage-of-Sales)
 - Balance sheet (Percentage-of-Receivables or Aging of Receivables)

Below is an example of an aging of accounts receivable to be used for the balance sheet-based approaches (see above), but we will begin with the income statement-based approach (see above):

				1 to 30	31 to 60	61-90	Over
			Not Yet	Days	Days	Days	90 Days
<u>Customer Account No.</u>	<u>Customer</u>	<u>Totals</u>	<u>Due</u>	<u>Past Due</u>	<u>Past Due</u>	<u>Past Due</u>	<u>Past Due</u>
56789	AAA Painting	\$500	\$500				
75543	XYZ Contracting	\$750			\$750		
12345	Pest Control, Inc.	\$1,250		\$1,250			
95455	Bob & Sons	\$900		\$300	\$600		

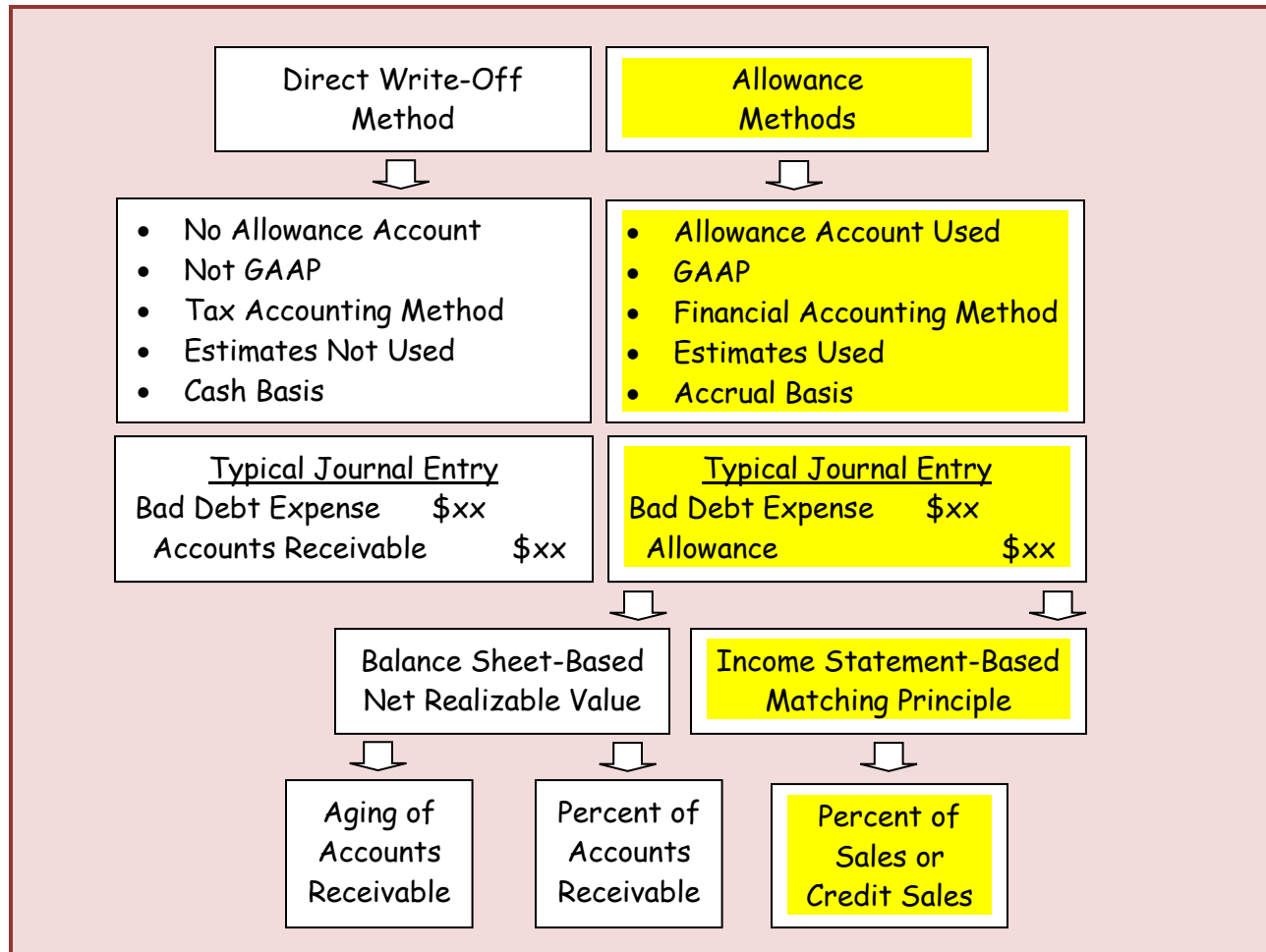
BREAK IN SEQUENCE

62358	Stores-R-Us	\$1,350				\$750	\$600
50001	Billy Bob	\$1,700	\$1,700	-	-	-	-
Total receivables		\$100,000	\$85,200	\$7,300	\$4,500	\$2,100	\$900
% uncollectible		3.4%	2.0%	5.0%	9.8%	25.2%	40.1%
Estimated uncollectible		\$3,400	\$1,704	\$365	\$441	\$529	\$361

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The Allowance Method – Income Statement-Based Percentage-of-Sales Approach

Patterns or trends in “credit” sales and related bad debts from prior years provide the basis for a reasonable estimate or projection or “matching” of the credit component of sales to bad debts for future accounting periods. If experience from prior periods suggests that 2% of credit sales for the current period are likely to become uncollectible, the following JE would be made:



Assume that your firm completes approximately 50% of sales for cash and 50% of sales on credit, as follows:

Cash Sales	\$100,000
Credit Sales	\$100,000
Total or Gross Sales	\$200,000

Further assume that your firm has decided on and consistently applies the income statement-based approach to estimating bad debts. They must, of course, have an aging of accounts receivable, as well, to management collections.

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Assume that 3.5% of credit sales, historically, have proved to be uncollectible. Using this historical experience rating on credit sales collections, you “match” the \$100,000 credit sales and \$200,000 total sales for the period (see above), with the expense, 3.5% or \$3,500 bad debt expense, as follows:

Bad Debt Expense	\$3,500
 Allowance for Doubtful Accounts	\$3,500

Note that the above journal entry does not take any existing allowance for doubtful accounts balance into consideration when matching the bad debt expense to credit sales for the period.

The next two variations of the balance sheet-based approach to valuing net realizable value of accounts receivable are, now, covered, where we begin with the percentage-of-receivables approach.

The Allowance Method – Balance Sheet-Based Percentage-of-Receivables Approach

Again, using past experience, a firm may estimate the allowance from an aging schedule. The aging of accounts receivable is reproduced, below, where a very simple computational example follows:

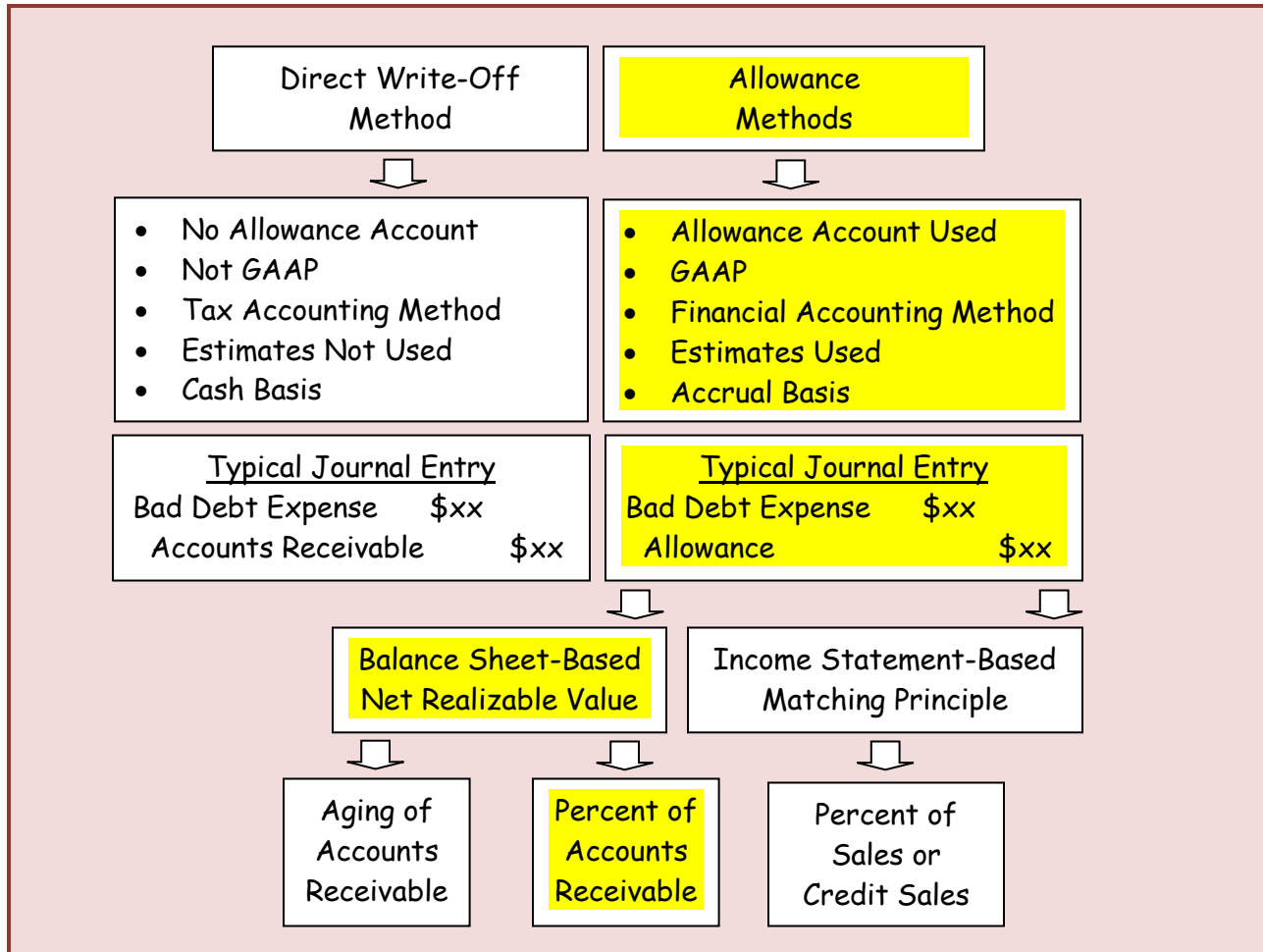
				1 to 30	31 to 60	61-90	Over
			Not Yet	Days	Days	Days	90 Days
<u>Customer Account No.</u>	<u>Customer</u>	<u>Totals</u>	<u>Due</u>	<u>Past Due</u>	<u>Past Due</u>	<u>Past Due</u>	<u>Past Due</u>
56789	AAA Painting	\$500	\$500				
75543	XYZ Contracting	\$750			\$750		
12345	Pest Control, Inc.	\$1,250		\$1,250			
95455	Bob & Sons	\$900		\$300	\$600		

BREAK IN SEQUENCE

62358	Stores-R-Us	\$1,350				\$750	\$600
50001	Billy Bob	\$1,700	\$1,700	-	-	-	-
Total receivables		\$100,000	\$85,200	\$7,300	\$4,500	\$2,100	\$900
% uncollectible		3.4%	2.0%	5.0%	9.8%	25.2%	40.1%
Estimated uncollectible		\$3,400	\$1,704	\$365	\$441	\$529	\$361

The above suggests that about 3.4% of total accounts receivable prove to be uncollectible, based on past experience. We will use this approach in the next example. Recall the flowchart framework:

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With \$100,000 in accounts receivable, we expect \$3,400 to be uncollectible. The allowance for doubtful accounts account already contains a credit balance of \$200. We must “match” the contra account balance to the accounts receivable balance with a “plug,” as follows:

Desired Allowance Balance	\$3,400
Less: Existing Allowance Balance	<u>\$200</u>
Equals: Additional Allowance Required	<u>\$3,200</u>

The journal entry to adjust or “plug” the allowance account to the desired balance and the presentation of accounts receivable in the balance sheet, where the net realizable value of accounts receivable is presented, follows:

Bad Debt Expense	\$3,200
Allowance for Doubtful Accounts	\$3,200
To adjust balance to \$3,400 or 3.4% of \$100,000.	

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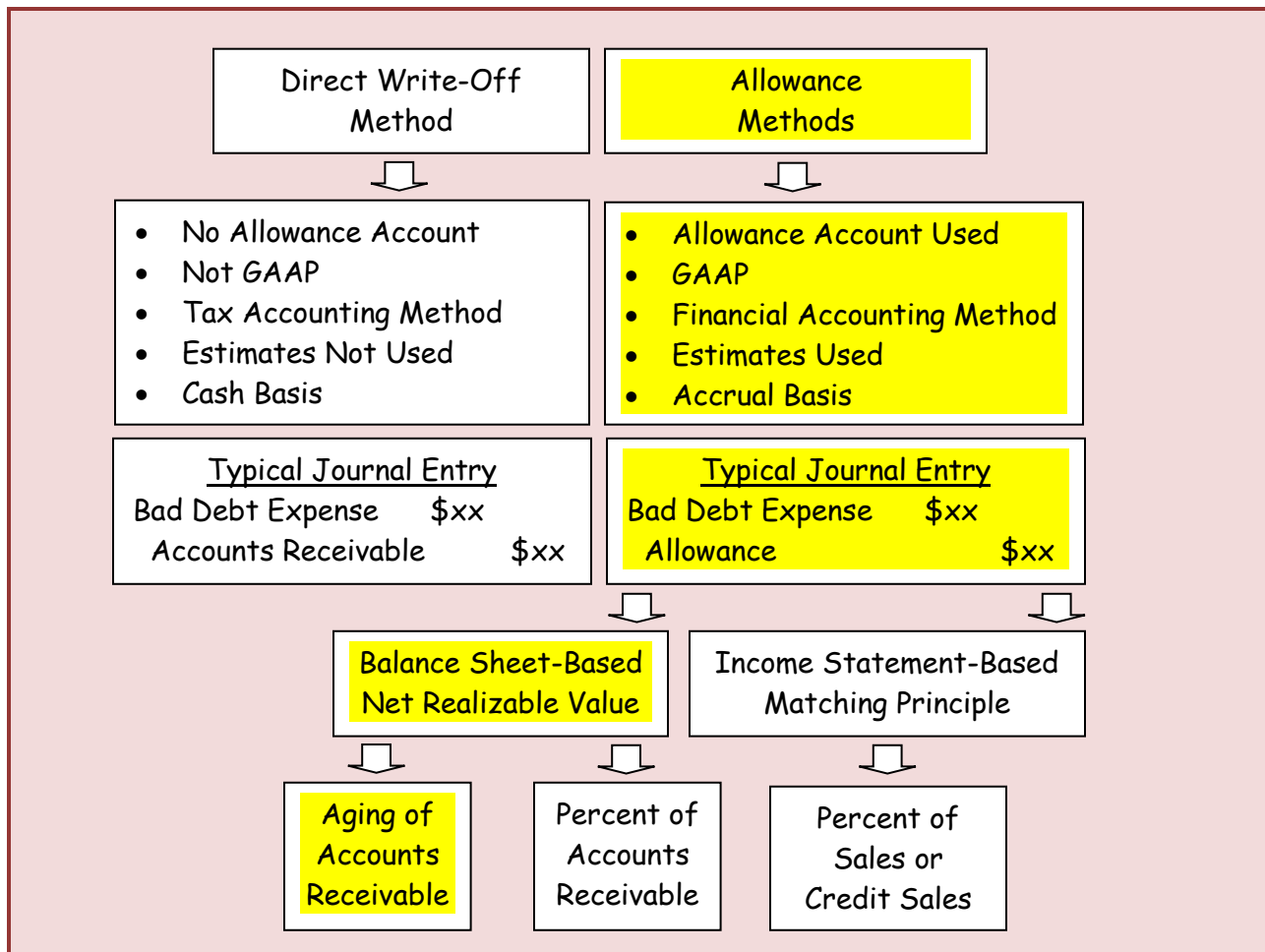
Current Assets	
Accounts receivable	\$100,000
Less: Allowance for doubtful accounts	<u>\$3,400</u>
Accounts receivable (net)	<u>\$96,600</u>

The Allowance Method – Balance Sheet-Based Aging of Receivables Approach

The relevant component of the same aging of accounts receivable is reproduced below, again, where, in this case, the same adjusting journal entry would be required, as follows:

Total receivables		\$100,000	\$85,200	\$7,300	\$4,500	\$2,100	\$900
% uncollectible		3.4%	2.0%	5.0%	9.8%	25.2%	40.1%
Estimated uncollectible		<u>\$3,400</u>	<u>\$1,704</u>	<u>\$365</u>	<u>\$441</u>	<u>\$529</u>	<u>\$361</u>

Bad Debt Expense	\$3,200
Allowance for Doubtful Accounts	\$3,200
To adjust balance to [$\$1,704 + \$365 + \$441 + 529 + \361] based on aging of accounts receivable.	



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The Allowance Methods - Comparing Balance Sheet and Income Statement Approaches

The balance sheet and income statement approaches may be viewed as directional. Both methods involve a debit to bad debt expense and both involve a credit to the allowance or allowance for doubtful accounts account. However, (1) the balance sheet approach begins with an adjustment to the desired balance to the allowance account or a “plug” and (2) the income statement approach begins with a matching of sales to the desired bad debt expense, as follows:

Balance Sheet Method:	CR Allowance for Doubtful Accounts	→	DR Bad Debt Expense
Income Statement Method:	DR Bad Debt Expense	→	CR Allowance for Doubtful Accounts

Both of the allowance methods would record an actual write-off of a particular bad debt against the allowance account, as follows:

Allowance for Doubtful Accounts	\$ XX	
Account Receivable		\$ XX

If a collection is later made on an account receivable previously written-off, the first step is to reverse the above entry, restoring the account receivable, as follows:

Account Receivable	\$ XX	
Allowance for Doubtful Accounts		\$ XX

An entry is, then, made to record the cash collection and credit the customer account, just as would be made in the event that the receivable had never been written off and had been collected in a timely manner, as follows:

Cash	\$ XX	
Account Receivable		\$ XX

Illustration of a Credit Sale Including Sales Tax Collections

Credit sales to retail customers include local sales taxes. For example, assuming a combined local and state sales tax rate of 6% and a \$100 sale, on credit, the following JE would be made by the retailer or seller:

Accounts receivable	\$106	
Sales		\$100
Sales tax payable		\$6

The retailer is acting as an intermediary and collecting the 6% or \$6 in sales tax, only to pay this amount to the taxing authority, typically, monthly. Therefore, if the entire account receivable is paid by the customer within 30 days, upon receipt of their billing

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statement, the sales tax collected would be sent to the taxing authority and the following JEs would be made:

Cash	\$106	
Accounts receivable		\$106

Sales tax payable	\$6	
Cash		\$6

If only half of the accounts receivable is paid within 30 days, only half of the sales tax payable must be sent to the taxing authority, as follows:

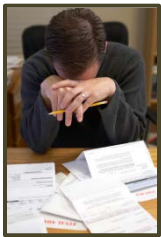
Cash	\$53	
Accounts receivable		\$53

Sales tax payable	\$3	
Cash		\$3

Therefore, while the retailer uses accrual accounting, the payment of the sales taxes collected by the retailer for the taxing authority must be paid to the taxing authority only when the cash is received (a cash basis approach). This is based on the “ability to pay” principle. It would be unreasonable to expect the retailer to send the sales tax to the taxing authority before the sales tax was actually collected.

Notes Receivable

Promissory notes or notes receivable are written promises to pay some specified amount, with stated (or imputed) interest, on demand or at some specific date or future point in time. On occasion, a vendor might require a note receivable to replace an account receivable (e.g., when a customer requests an extension of time to pay a past due note). The seller (or vendor) requires the replacement of the trade account receivable with a note receivable to formalize the debtor’s acknowledgement of the debt in the event of litigation – if a lawsuit becomes necessary to collect the debt. The note would specify the (1) principal amount, (2) interest rate, (3) maker of the note, and (4) payee of the note.



The journal entry used to reclassify a \$5,000 trade account receivable to a note receivable follows:

Note receivable	\$5,000	
Accounts receivable		\$5,000

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The terms of the note payable are specified in the promissory note. In this case, the annual rate of interest is 10 percent. Both principal and interest on the note is due in 90 days, as follows:

Principle X Annual interest rate X Fraction of a year = Interest

or

\$5,000 X 10% X 90/365 = \$123 (rounded)

or

\$5,000 X 10% X 90/360 = \$125

Notice that local business practice and the form of the note will determine whether interest is computed on a 365 day year (\$123; above) or a 360 day year (\$125; above). We will base our interest computations on the assumption of a 360 day year.

If paid, 90 days after the terms are agreed to and the note is signed, the following journal entry is made:

Cash	\$5,125
Note receivable	\$5,000
Interest income	\$125

The recipient will credit the *interest revenue* or *interest earned* or *interest income* account for the \$125 generated from the note receivable.

Dishonored Notes

If a note is dishonored, due to refusal or inability to pay, the payee is likely to take all reasonable actions to collect. In the interim, and continuing with the same fact pattern from the above example, the note is charged back to the account receivable account, as follows:

Accounts receivable	\$5,125
Note receivable	\$5,000
Interest income	\$125

End-of-Period Interest Accruals

Any notes receivable outstanding at the end of an accounting period require an accrual to “book” the interest income and receivable prior to the preparation of the firm’s balance sheet and income statement. The interest earned during the period must be “matched” to the period.

Assume that Belak Enterprises has a 90-day, 12% note receivable due at the end of February 2015, but is preparing their December 2014 year-end financial statements for a \$10,000 note. The below journal entry must be made on December 31, 2014:

Interest receivable	\$100
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Interest income	\$100
To accrue interest at 12% for 30 days.	

When collected, on February 28, 2015, the following journal entry will be made:

Cash	\$10,300	
Interest receivable		\$100
Interest income		\$200
Note receivable		\$10,000

Selling Receivables

Accounts receivable, like any asset, can be sold. In the case of accounts receivable, the buyer (factor) charges a factoring fee. The seller converts the accounts receivable to cash and the risk of default (bad debt) passes to the factor. Assume, for example, that Belak Enterprises sells \$10,000 of their accounts receivable, is charged a 5% factoring fee, and records the sale:

Cash	\$9,500
Factoring fee expense	\$500
Accounts receivable	\$10,000

Accounting for the sale of a note receivable would be comparable.

Pledging Receivables

Instead of selling receivables, a firm might simply borrow money and pledge the receivables as security for the loan. This would not transfer the risk of the bad debt, since there is no buyer, and ownership of the receivable does not transfer. The lender has the right to receive proceeds from the receivable when received.

For example, assume that Belak Enterprises pledges \$20,000 in receivables in return for \$15,000:

Cash	\$15,000
Notes receivable	\$15,000

Terms would be disclosed in footnotes to the financial statements.

Appendix A

Accounts Receivable Turnover

Accounts receivable evolve from credit sales, since cash sales are paid for with cash, as follows:

CASH SALE

Cash	\$750
Sales	\$750

CREDIT SALE

Accounts Receivable	\$750
Sales	\$750

Accounts receivable must be collected, and one indicator of superior management is the speed with which these collections occur. There are industry averages available to compare a specific firm's performance against. The basic formula for the computation of accounts receivable turnover follows:

$$\text{Accounts receivable turnover} = \text{Net sales} \div \text{Average accounts receivable (net)}$$

As is the case with all turnover measures, the numerator comes from the income statement, covering a period of time, and the denominator comes from both beginning and ending balance sheets, or the average of the beginning of the period and the end of the period.

Appendix B

Sales Journal

Cash sales are recorded in the cash receipts journal, but credit sales must also be recorded in some fashion. Credit sales are recorded in the sales journal.

CASH SALE - RECORDED IN THE CASH RECEIPTS JOURNAL

Cash	\$750
Sales	\$750

CREDIT SALE - RECORDED IN THE SALES JOURNAL

Accounts Receivable	\$750
Sales	\$750

Assume that there are 4 cash sales during a period:

1. one cash sale for full price at \$250,
2. one cash sale for \$500, but resulting in a sales return for the full amount and the very next day and within the same period, so resulting in a cash disbursement,
3. one cash sale for \$750, but resulting in a sales discount of \$100, immediately upon sales, and
4. one cash sale for \$1,000, but resulting in a sales allowance of \$50, due to the identification of damage, and within the same period of sale.

This is how these cash sales transactions would appear in a cash receipts journal, where you would, first, record the cash sales:

	DR	CR	DR	DR	DR	DR
	Cash	Sales	Accounts Receivable	Sales Returns	Sales Discounts	Sales Allowances
Transaction 1	\$250	\$250				
Transaction 2	\$500	\$500				
Transaction 3	\$750	\$750				
Transaction 4	\$1,000	\$1,000				
	<u>\$2,500</u>	<u>\$2,500</u>	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>

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The sales returns, sales discounts, and sales allowances would be recorded in a cash receipts journal, as follows:

<u>Transaction</u>	CR		DR	DR	DR	DR
	<u>Cash</u>	<u>Sales</u>	<u>Accounts Receivable</u>	<u>Returns</u>	<u>Sales Discounts</u>	<u>Sales Allowances</u>
1						
2	\$500			\$500		
3	\$100				\$100	
4	\$50					\$50
	<u>\$650</u>	<u>\$0</u>	<u>\$0</u>	<u>\$500</u>	<u>\$100</u>	<u>\$50</u>

This is how these credit sales transactions would appear in a sales journal, where it is assumed that all of these sales generated accounts receivable and occurred on credit:

<u>Transaction</u>	DR	CR	CR	DR	DR	DR
	<u>Cash</u>	<u>Sales</u>	<u>Accounts Receivable</u>	<u>Returns</u>	<u>Sales Discounts</u>	<u>Sales Allowances</u>
1						
2			\$500	\$500		
3			\$750		\$100	
4			\$1,000			\$50
	<u>\$0</u>	<u>\$0</u>	<u>\$2,250</u>	<u>\$500</u>	<u>\$100</u>	<u>\$50</u>