

CLASSIFICATION OF RECEIVABLES

Receivables: Includes all money claims against other entities, including people, business firms, and other organization.

- ☞ **Accounts receivable:** The most common transaction creating a receivable is selling merchandise or services on credit. The receivable is recorded as a debit to the accounts receivable account. Accounts receivable are normally expected to be collected within a relatively short period, such as 30 or 60 days. They are classified on the balance sheet as a current asset.
- ☞ **Notes receivable:** Are amounts that customers owe for which a formal, written instruction of credit has been issued. It's classified as a current asset if it can be collected within a year.

UNCOLLECTIBLE RECEIVABLES

Bad debt expense: The operating expense recorded from uncollectible accounts receivables. Accounts become uncollectible when a customer does not pay after a specified period, declares bankruptcy, or dies. Companies use several different methods to recognize the uncollectible account as follows:

- ☞ **Direct write-off method:** Records bad debt expense only when an account is judged to be worthless.

DIRECT WRITE-OFF METHOD

When an account becomes uncollectable we write the account off to bad debt expense. This removes the receivable and recognizes an expense in the period in which it becomes uncollectable.

- ☞ Assume that on March 3rd, a \$4,200 account receivable from Rosalyn Monte has been determined to be uncollectible. The entry to write off each individual account as it becomes uncollectible is:

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3-3	Bad Debt Expense	4,200	
	Accounts Receivable-Monte		4,200

This reduces Rosalyn Monte's account to zero and recognizes the expense.

Accounts Receivable		Bad Debt Expense	
538,000	4,200	4,200	
533,800			

The problem with this method is that it does not match the revenues with the expenses in the same period.

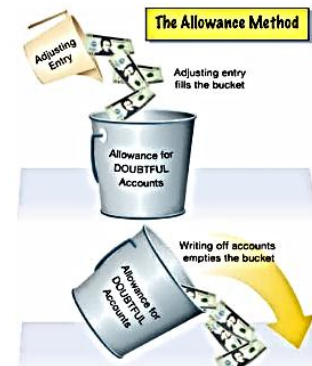
ALLOWANCE METHOD

When we use the allowance method for uncollectable accounts, the company is following the idea of the matching concept. The matching concept requires us to match the revenues earned with the expenses incurred to earn them

- ☞ **Allowance method:** Records bad debt expense by estimating uncollectible accounts at the end of the accounting period.
- ☞ **Allowance for Doubtful Accounts:** The contra asset is used to recognize the decrease in the accounts receivable account rather than reducing the balance directly.

When a fisherman goes fishing, he must first get bait. The credit adjustment to the Allowance account fills our Allowance (bait) bucket with our estimated uncollectible.

Throughout the accounting period as accounts become uncollectible, we simply debit the allowance account and zero out their accounts receivable. We don't use the Bad Debt Expense account because we recognized all the bad debts at the beginning of the period when we did the adjustment.



Analysis Of Receivables Method (Aging Of Receivables)

The analysis of receivables method is based on the assumption that the longer an account receivable is outstanding, the less likely that it will be collected.

Receivables are grouped by the length of time outstanding and then each age group is multiplied by the percentage that is believed to become uncollectible.

Percentage Of Sales Method

This method estimates the expected uncollectable amount based on industry averages or past history. If Azteck Co, found that 2% of all sales in 2012 became uncollectible, 1.98%, in 2011 and 2.1% in 2010, then they can use 2% as a realistic expectation of what will become uncollectible in the current year.

$$(2\% + 1.98\% + 2.1\% = 6.08\% \div 3 = 2.026666667 = 2\%)$$

