


Chapter 7, Module 2

Slide 1

Chapter 7 Module 2

AMIS 211
Introduction to Financial Accounting

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 **FISHER**
COLLEGE OF BUSINESS

Hi everyone. Welcome back.

Let's continue our discussion of selling our product. And, we are dealing with the Sales Revenue and Accounts Receivable part of that.

And, let's spend some time on Accounts Receivable.

Let's move onto the next slide.

Slide 2

Chapter 7 Module 2: Accounts Receivable

ACCOUNTS RECEIVABLE

- **Accounts receivable represent cash owed to the company.**
- **Accounts receivable come about when the company makes a credit sale (i.e., a sale on account)**
- **Big issue when you sell goods on account.....**

And remember: Accounts Receivable represent cash that is owed to the company.

They come about when we make a sale of goods on account.

We sell goods to our customers, who take the goods and say: “I will pay you later.”

It is commonplace. It happens all the time in business.

Of course, there is one big issue that we have to worry about whenever we sell goods on account.

What do you think that is?

What is going to be the one concern that we are going to run into when we sell goods on account?

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Slide 3

Chapter 7 Module 2: Bad Debts

NOT ALL CUSTOMERS PAY THEIR BILLS!

Thus, the company must record BAD DEBT EXPENSE each year

QUESTION: In which year should bad debt expense be recorded?

- A. In the year the credit sale is made**
- B. In the year the account receivable is determined to be uncollectible**

The concern is: not everybody is going to pay us. Not all customers actually pay their bills!

So, what are we going to do when customers fail to pay us what they owe us?

In this case, because not all customers pay us, we must record what is called bad debt expense. And bad debt expense needs to be recorded every year.

So, every year—because of the fact that not all customers are going to pay; it is just a fact of doing business—we are going to have to record bad debt expense.

Now, I have a question for you:

In which year should we record the bad debt expense related to a specific sale?

I am going to give you two options—and I want you to think about it for a second. And, I want you to tell me: what would be the correct answer.

In which year would we record bad debt expense? Would we record it, a): in the year that we actually make the credit sale; or b): in the year that we determine the customer won't pay us?

Now, before we answer this, I just would like to take a second and explain why these two years typically do not fall within the same period—these two transactions—making the sale and then determining the customer won't pay us—they typically do not fall in the same year.

Here is what happens:

You make a sale to somebody. Say, you make a sale to Marc Smith.

And, you say: “Okay, Credit Terms are: 2/10, n60. So, Marc, you have to pay me within 60 days.”

And, I say, “Okay.” And, I take the goods.

60 days go by and, of course, I do not pay you.

What are you going to do?

You are not going to immediately say: “Oh, my goodness! This customer is not going to pay us. Let's eliminate him!”

Of course not! You are going to try to collect your money.

So, you are going to send me a letter in the mail. And the letter is going to say: “Oh, just a friendly reminder that you owe me money. I am sure the check is in the mail. If our letters have crossed, please disregard this.” And, there will be a big happy face at the bottom of that letter.

Of course, I ignore it. So, I do not send in anything.

Another 30 days go by and you send me another letter. This one is not quite as friendly. It says: “Look, Jerk! You owe me money. Send it in now.” And, there is a skull and crossbones on it.

Of course, I kind of laugh and say: “Nope! I am still not going to send in the cash.”

You give me another 30 days. No money.

Now, you have a Collection Agency try to get the money from me. They are calling me at home. They call me at work. They call my family. They are trying to harass me to a point where I will pay you.

Of course, it does not bother me. I just do not have any phones.

So, you give the Collection Agency, maybe 60 days, to try to collect the cash. You still cannot get your money.

Now, you are really mad. Now, you are waiting outside of my car with a big stick. You are going to beat the money out of me.

Of course, I am too fast. So, you cannot catch me and you still do not get your cash.

Eventually, after exhausting all of these options—the friendly letter, the unfriendly letter, the Collection Agency, even the big stick—eventually, you just say: “This is just not worth my time anymore. I am spending more money trying to collect this cash from this loser than I would get if I actually got the cash. It is just not worth my time. Let’s report him to the Credit Agency and simply get rid of him as an Account Receivable.”

But, at that point, when you finally make that decision, you have typically moved into the next accounting period.

So, the question after that long involved discussion:

In which of those accounting periods should the bad debt be recorded? Is it in the year you make the sale or the year you finally determine the customer won’t pay you after exhausting all of your attempts?

Please go to the next slide with me to take a look at the answer.

Slide 4

Chapter 7 Module 2: Bad Debts

ANSWER: **Bad debt expense must be recorded in the same year as the credit sale is made.**

RATIONALE: **MATCHING CONCEPT**

Expenses are to be recorded in the same year they help to generate revenues. Revenue is earned when the sale is made, thus bad debt expense must be recorded in the same year.

The answer is: You record bad debt expense in the same year that the sale is made.

So, bad debt expense is recorded in the same year as the credit sale.

Why?

The rationale for this is: our good friend, the Matching Concept.

The Matching Concept says: Expenses must be recorded in the year they helped to generate revenue. The revenue is generated when this sale is made. Hence, the expense must be recorded in the same year.

You must match the bad debt expense to the sales revenue that is generated when you sell goods on account.

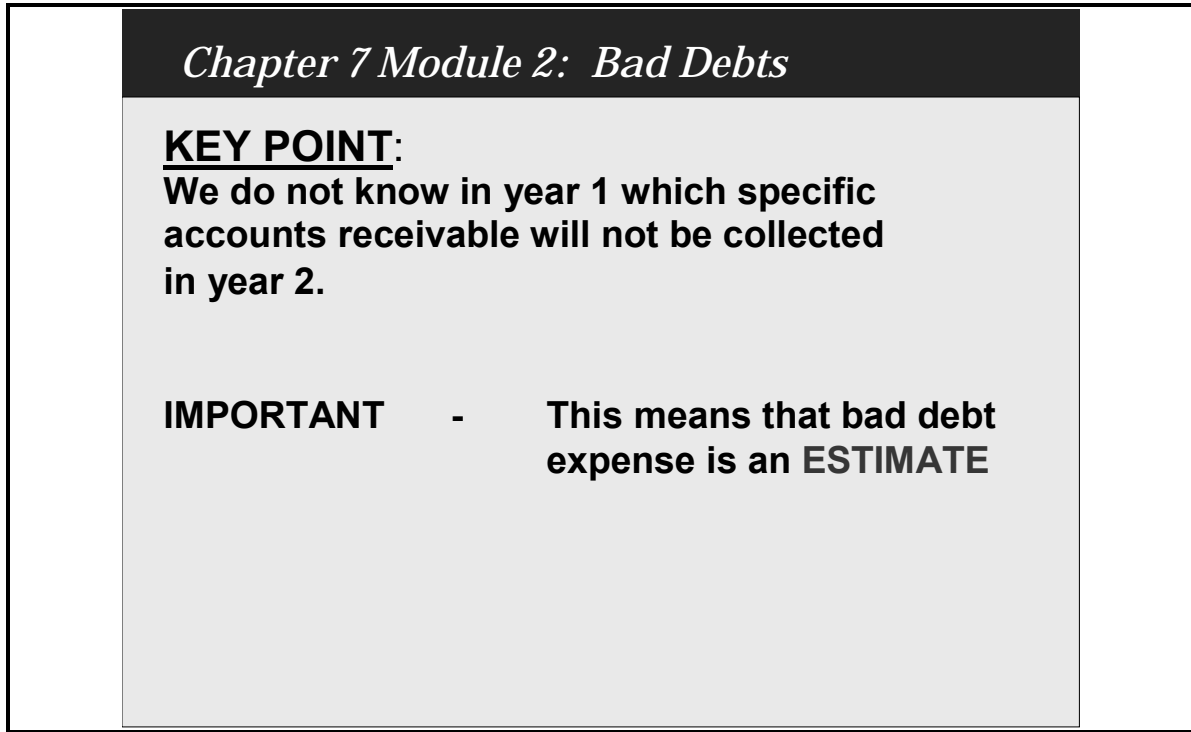
Saying it again:

Bad debt expense must be recorded in the same year as the credit sale is made, in order to conform to the Matching Concept.

But, it is going to cause us a big problem.

Please go to the next slide.

Slide 5

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Chapter 7 Module 2: Bad Debts

KEY POINT:
We do not know in year 1 which specific accounts receivable will not be collected in year 2.

IMPORTANT - This means that bad debt expense is an ESTIMATE

Key Point:

In the year of the credit sales, we do not know which specific customers won't pay us. If we knew which specific customers would not pay us, we just would not sell to them.

So, we do not know which customers won't pay us. We just know that there is some percentage that won't.

That is history. That is the way it works, unfortunately. We do not know the specific individuals that won't pay. We just know that some percentage won't pay.

However, because bad debt expense must be recorded in Year 1—the year you make the sale—to conform to Matching—this means bad debt expense is an estimate.

We do not know who will and will not pay us. If we knew who would not pay us, we would not sell to them.

However, to conform to Matching, the expense needs to be recorded in the year we make the sale. Thus, bad debt expense is an estimate.

That is key. That is crucial. You want to recognize this.

Because of this Matching Concept, bad debt expense must be estimated.

Now, please go to the next slide.

Slide 6

Chapter 7 Module 2: Bad Debts

To record the bad debt expense estimate:

| General Journal | | | |
|-----------------|--|----------|----------|
| Date | Account Titles | Debit | Credit |
| Dec. 31 | Bad Debts Expense | X | |
| | Allowance for Doubtful Accounts | | X |
| | | | |

Note: The above entry is made at the end of every year thus it is an adjusting entry.

To record the bad debt expense estimate—this is made every year as part of the adjusting process. To record the bad debt expense estimate: that is the Journal Entry.

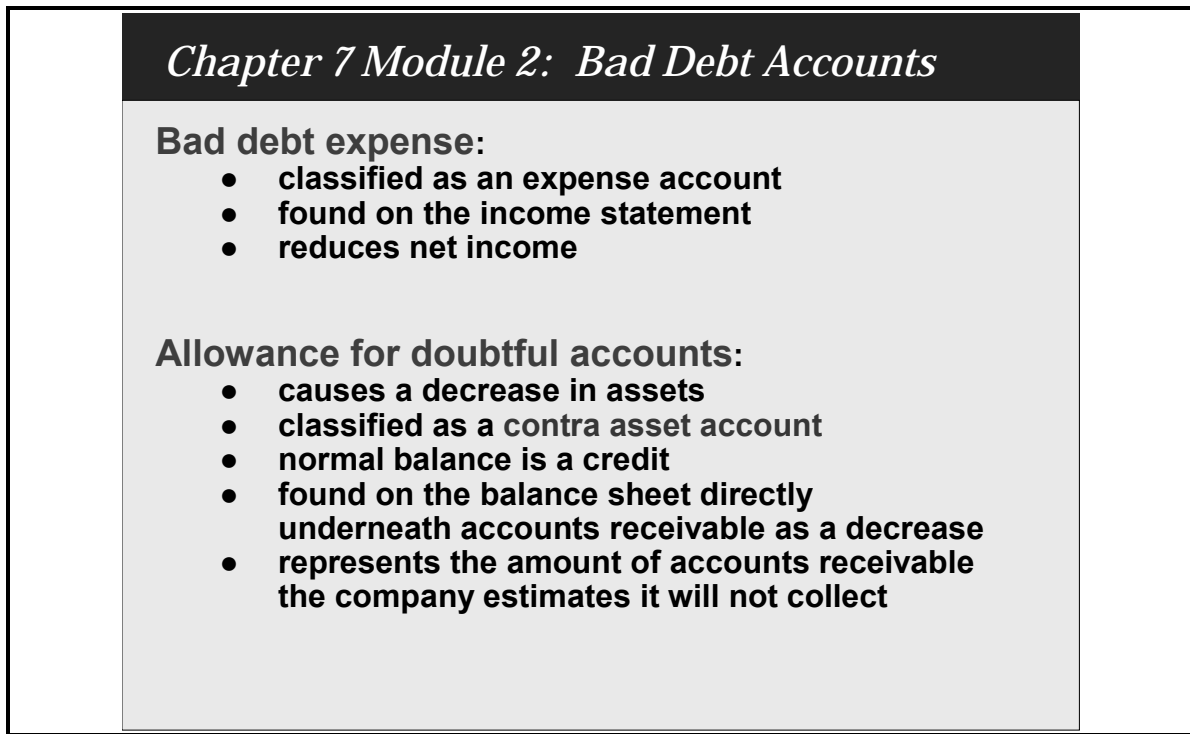
You debit Bad Debt Expense for whatever the amount that you estimate is and you credit this new account called the Allowance for Doubtful Accounts.

You debit the Bad Debt Expense and credit the Allowance for Doubtful Accounts.

Notice that the above entry—that entry you see there—the entry to debit Bad Debt Expense—is done at the end of every year making it part of the adjusting process. It is an Adjusting Journal Entry (AJE).

Now, please go to the next slide.

Slide 7

A rectangular box with a black border containing text about bad debt accounts. The title is in a dark grey bar at the top. Below it, two sections describe 'Bad debt expense' and 'Allowance for doubtful accounts', each with a bulleted list of characteristics.

Chapter 7 Module 2: Bad Debt Accounts

Bad debt expense:

- **classified as an expense account**
- **found on the income statement**
- **reduces net income**

Allowance for doubtful accounts:

- **causes a decrease in assets**
- **classified as a contra asset account**
- **normal balance is a credit**
- **found on the balance sheet directly underneath accounts receivable as a decrease**
- **represents the amount of accounts receivable the company estimates it will not collect**

And, let's talk about these two accounts in this Adjusting Entry (AJE).

We will start with the easier one: Bad Debt Expense.

That is simply classified as an Expense account, which means that it is found on the Income Statement.

And, since it is an Expense account, it reduces (-) Net Income.

The Allowance for Doubtful Accounts is a new account—one that is not quite as obvious—causes a decrease (-) in our Assets, which means—and before I reveal the answer, you tell me—or you tell the computer screen: what type of account is it?

If it causes a decrease (-) in Assets, the Allowance for Doubtful Accounts is classified as a Contra-Asset account.

The Contra-Asset account—opposite of Assets—carries a Normal Balance on the credit side.

The Normal Balance of an Asset is a debit. The Normal Balance of a Contra-Asset is a credit.

In addition, the Allowance for Doubtful Accounts is found on the Balance Sheet directly underneath the Accounts Receivable as a decrease (-).

Again, these are bullet-point characteristics that you should be able to list out for every account we talk about.

The Allowance for Doubtful Accounts is a Contra-Asset because: it reduces Assets. It is found on the Balance Sheet directly under Accounts Receivable as a decrease (-). The Normal Balance is a debit.

One other characteristic of the Allowance:

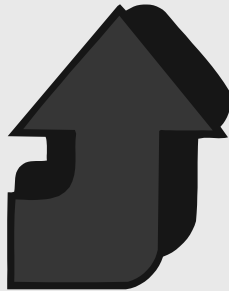
The Allowance for Doubtful Accounts represents our estimate of our Accounts Receivable that we do not think we will collect.

We recognize that not everybody pays us. So, we have to estimate how much of the Receivables we do not think we will collect. That estimate is what is found in this Allowance for Doubtful Accounts.

Remember what financial statement it is found on: it is found on the Balance Sheet right underneath Accounts Receivable.

Go to the next slide with me.

Slide 8

| <i>Chapter 7 Module 2: Bad Debt Accounts</i> | | | |
|--|---------------|--|---|
| XYZ Company Balance Sheet (partial) | | | |
| Current assets | | | |
| Cash | | | \$ 14,800 |
| Accounts receivable | \$200,000 | | |
| Less: Allowance for doubtful accounts | <u>12,000</u> | | 188,000 |
| Net Realizable Value | | |  |

And, let's look at a Balance Sheet—a partial Balance Sheet.

You start with your Current Assets. You have your Cash; say \$14,800.

The next account we are going to see is Accounts Receivable.

And, right under—and this is the new part—right underneath the Accounts Receivable is the Allowance for Doubtful Accounts as a decrease (-).

So, you take the Receivables: \$200,000; and subtract (-) the Allowance—that is the Contra-Asset—and that gives you this difference of: \$188,000.

Now, this difference is a very important calculation—a very important formula—that you will want to be comfortable with:

The Accounts Receivable minus (-) the Allowance for Doubtful Accounts is called the company's Net Realizable Value (NRV).

So, the NRV—or Net Realizable Value—is simply equal (=) to the Accounts Receivable minus (-) the Allowance for Doubtful Accounts.

That is definitely something we will see a lot of as we move forward with this discussion.