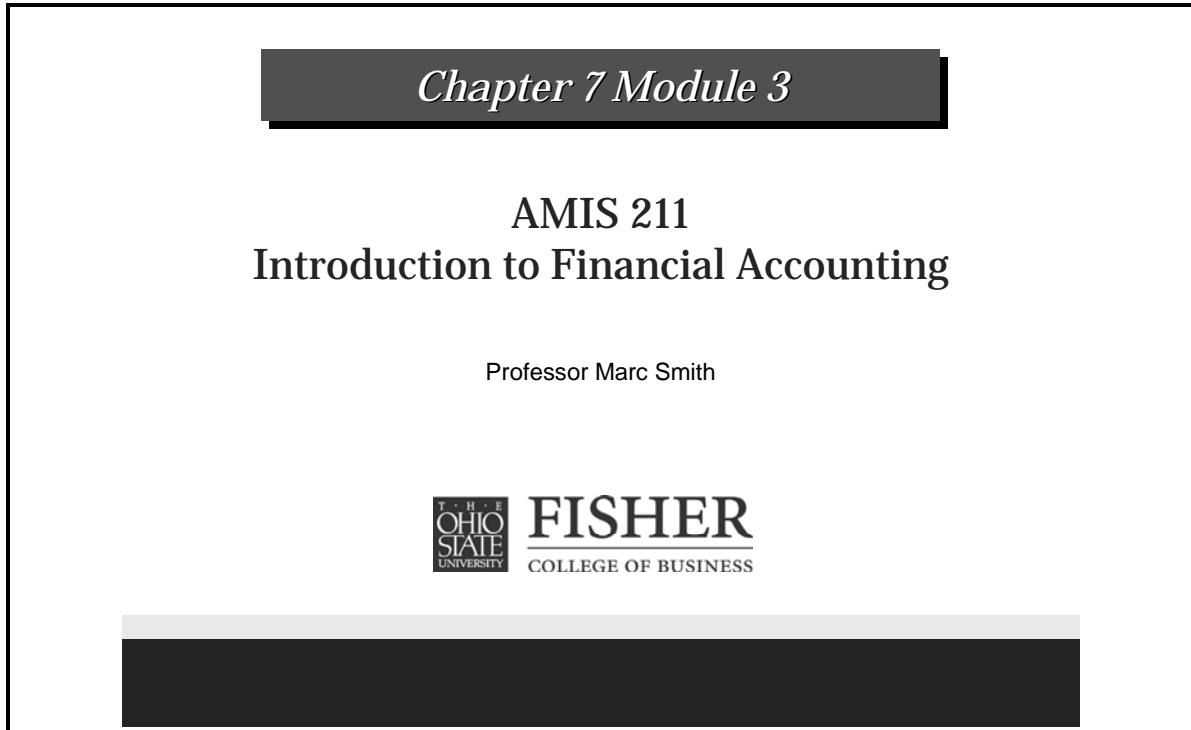


**Chapter 7, Module 3**

**Slide 1**

A rectangular box with a black border containing the slide content. At the top, a dark grey horizontal bar contains the text "Chapter 7 Module 3" in a white, italicized serif font. Below this, the text "AMIS 211" and "Introduction to Financial Accounting" is centered in a black serif font. Underneath, "Professor Marc Smith" is centered in a smaller black serif font. At the bottom center, the logo for Fisher College of Business at Ohio State University is displayed, featuring a small square icon with "T.H.E. OHIO STATE UNIVERSITY" and the text "FISHER COLLEGE OF BUSINESS" to its right. At the very bottom of the box, there are two horizontal bars: a light grey one on top and a dark grey one below it.

Hi everyone. Welcome back.

Let's go ahead and continue our discussion of Accounts Receivable.

And, remember where we left off:

We left off saying: "Hey look! When you sell goods on account, not everybody pays." It is a fact of doing business. So, we have to record what is called: bad debt expense.

So, let's just pick up right there.

And, let's move to the next slide.

Slide 2

*Chapter 7 Module 3: Bad Debts*

**Remember – we estimate the amount of bad debt expense in order to adhere to the Matching Concept**

- ▶ **The issue here is that the company does NOT know when the estimate is made which customers will not pay – they only know that some will not pay**

**QUESTION: What happens when the company determines a specific customer will not pay?**

And, let's remember that bad debt expense is an estimate.

It must be estimated. We need to record it immediately when the sales happen in that same year in order to conform to the Matching Concept—in order to conform to Generally Accepted Accounting Principles (GAAP).

So, bad debt expense is an estimate.

Now, the issue here is: we don't know which customers won't pay us. We don't know which specific individual customers won't pay. We only know that there is some percentage of those folks that will not pay their bill. That is why we make an estimate of bad debt expense every year.

So, the question, then, becomes:

What do you do when you finally decide that a customer won't pay you?

Remember in the previous Module my example about: you make a credit sale to me; I don't pay; so then you go through all of this process of trying to collect; and after you exhaust all of these different ways of trying to collect,

you finally say: “It is just not worth my time anymore. We need to eliminate that customer from our Balance Sheet.”

And, we said, “Well, look! That is not when the bad debt expense is recorded.” It is recorded in the year of the credit sale to conform to Matching.

So, what do you do when you finally decide this specific individual customer is not going to pay their bill?

Move to the next slide.

### Slide 3

***Chapter 7 Module 3: Write-Offs***

**ANSWER: They must write-off the customer's account receivable**

General Journal			
Date	Account Titles	Debit	Credit
<b>Any</b>	<b>Allowance for Doubtful Accounts</b>	<b>X</b>	
	<b>Accounts Receivable</b>		<b>X</b>

**Note: A write-off can occur at any point during the year. Write-offs represent the actual bad debts of the company.**

What you do is: you have to what is called: write-off the customer's Accounts Receivable.

So, when you finally make the decision that there is a customer that will not pay their bill no matter what you have tried to do. You finally may say: “It is not worth trying to collect anymore”; you write-off their Accounts Receivable.

To write-off a customer's Account Receivable, you can see the entry right there.

You debit the Allowance for Doubtful Accounts. And, you credit the Accounts Receivable.

So, a write-off: debit the Allowance; credit the Accounts Receivable.

Now, something that is important to know about these write-offs:

The write-offs can occur at any point in time during the year. The bad debt expense estimate is an Adjusting Entry (AJE) made at year-end. But, write-offs, they can occur all throughout the year.

You are going through the process of trying to collect. You will eventually say: "It is just not worth my time anymore" and write-off the customer's account.

You can think of the write-offs as the actual bad debts for the company. Because: a write-off is an actual number. It is me saying: "Look, this customer won't pay me."

The bad debt expense is an estimate. It is done to conform to the Matching Concept or GAAP (Generally Accepted Accounting Principles).

Write-offs can occur at any point in time and they actually represent the actual bad debts of the company.

Now, if you would go to the next slide with me.

Slide 4

*Chapter 7 Module 3: Write-Offs*

**2 Key Points About The Write-Off Entry:**

- 1) **It does NOT effect bad debt expense**

**This is very important! Bad debt expense is estimated at the end of each year. Thus, when a specific account is written-off, we do not record bad debt expense again – this would be double-counting! Instead, we simply eliminate the account receivable and reduce the allowance for doubtful accounts**

There are two (2) key points that you need to recognize about the entry to record a write-off—two (2) key points about the write-off of an Account Receivable.

Now remember what the entry was: debit Allowance for Doubtful Accounts; credit Accounts Receivable.

Key Point #1: That entry does not affect in any way the bad debt expense. It is not part of the expense on the Income Statement.

The reason for this: you have already recorded that.

We have already estimated the bad debt expense in a previous year in order to conform to the Matching Concept.

So, when you have an actual write-off, you do not want to record bad debt expense again. It would be like double-counting the expenses. And, nobody wants to do that!

So, Key Point #1: The write-off of a customer's Account Receivable does not affect bad debt expense.

Go to the next slide with me.

Slide 5

**Chapter 7 Module 3: Write-Offs**

**2) The write-off of an account receivable has no effect on the net realizable value (NRV)**

**NRV = Accts receivable - Allowance**

**This is counter-intuitive, yet true! The write-off entry reduces both the accounts receivable and the allowance for doubtful accounts, leaving the difference between the two accounts (net realizable value) unchanged.**

Key Point #2: The write off of an Account Receivable also has no effect—it does not effect in any way—the Net Realizable Value (NRV) of your Accounts Receivable.

Now, remember what the NRV is:

It represents the Accounts Receivable minus (-) the Allowance for Doubtful Accounts.

A write-off of a Receivable has no effect, whatsoever, on the NRV.

Now, this is really important.

These sorts of questions pop up on Exams all the time.

It is counter-intuitive. You would almost want to say: “Hey! That does not make sense! You write-off an Account Receivable: that should reduce the NRV.”

**NOT TRUE!**

The write-off has no effect on the NRV because if you go back just a couple of slides, you will see the Journal Entry.

The write-off reduces both the Accounts Receivable and the Allowance for Doubtful Accounts.



When you reduce both sides of the subtraction by the same amount, the difference—called the NRV, in this case—is unchanged.

This is a crucial point. It is well worth being comfortable with. You can guarantee you will be asked about it on a Quiz as well as the Exam.

Let’s see if we can illustrate it with some numbers.

Please go to the next slide with me.

## Slide 6

<i>Chapter 7 Module 3: Write-Offs</i>			
Before Write-off of \$500 Acct Receivable			
Accounts receivable	\$200,000		
Less: Allowance for doubtful accounts	<u>12,000</u>	188,000	
Net Realizable Value			
After Write-off of \$500 Acct Receivable			
Accounts receivable	\$199,500		
Less: Allowance for doubtful accounts	<u>11,500</u>	188,000	
Net Realizable Value			

And, if you remember in the last Module—near the end—we just showed how the Accounts Receivable and the Allowance would appear on a Balance Sheet.

And, there it is.

So, let's say that you have an Accounts Receivable of \$200,000 and the Allowance for Doubtful Accounts is \$12,000. That \$188,000 is, of course, our Net Realizable Value (NRV).

And, say that is before we have a \$500.00 write-off.

After the \$500.00 write-off—after we write-off a \$500.00 Account Receivable—the balance in the Accounts Receivable is decreased to \$199,500. But, the Allowance for Doubtful Accounts has also decreased to \$11,500.

Note: the Net Realizable Value (NRV) is unchanged at \$188,000.

It is the mathematics behind a subtraction—reducing both sides of a subtraction by the same amount has no effect on the difference.

So, when we reduce both the Accounts Receivable and the Allowance by the same dollar amount when we write-off a Receivable, the NRV, or difference, is unchanged.

And, that really is counter-intuitive.

Most folks would probably want to say that it would reduce the NRV.

NOT TRUE!

A write-off has no effect.

So, we have really dealt with the two (2) key issues to this point—1) the estimation of bad debt expense, 2) the write-off of an Account Receivable.

We have one other issue to deal with.

Please go to the next slide.

## Slide 7

**Chapter 7 Module 3: Recovery**

**If a customer pays their bill after the company has written-off their account receivable, it is called a recovery. To record a recovery:**

General Journal			
Date	Account Titles	Debit	Credit
<b>Any</b>	<b>Cash</b>	<b>X</b>	
	<b>Allowance for Doubtful Accounts</b>		<b>X</b>

It is rare—but it can happen—when you have a customer that pays you after you have written-off their Account Receivable.

So, you try to collect from me. And, you go through all of the steps to try to collect and I do not pay you. So, you finally say: “It is just not worth my time and effort anymore” and, you write-off my Account Receivable. So, you do it. And then, after you do that, I send in payment.

This is referred to as a Recovery—a recovery of a previously written-off Account Receivable.

To record a Recovery, you simply debit the cash that you collect and you credit the Allowance for Doubtful Accounts.

For a Recovery—you debit Cash; credit the Allowance for the amount that you receive.

Now, if you would please go to the next slide with me.

## Slide 8

***Chapter 7 Module 3: Allowance Dbt Accts.***

<b><i>Allowance for Doubtful Accounts</i></b>	
<i>Write-offs</i>	<i>Recoveries</i>
	<i>Bad debt expense</i>

**NOTE:      Bad debt expense is an estimate  
Write-offs are an actual amount.**

I would like to wrap up this Module with a T-Account for the Allowance for Doubtful Accounts.

What impacts this Allowance?

We have looked at three (3) specific things—three (3) specific transactions that effect the Allowance.

One of them is 1) the bad debt expense estimate. That increases the Allowance. The Allowance is a Contra-Asset. So, the increase side is the credit side.

The other item or the other big item that effects the Allowance is 2) write-offs. When you write-off an Account Receivable, you reduce the Allowance.

Those are the two (2) crucial items. Increase side: the bad debt expense; decrease side: the write-off.

Now, tell me:

What is the difference between those two items? What is the distinction between bad debt expense and write-offs?

It is that: bad debt expense is an estimate. Bad debt expense is just our estimate of what we think is uncollectible.

The write-offs are your actual bad debts. These are the actual accounts that you have determined cannot be collected.

That is a very important distinction. We will revisit that in the next Module.

So, the Allowance is increased by the bad debt expense estimate and decreased by write-offs; those are the two big items.

There is one additional item affects the Allowance:

That would be your Recoveries.

Notice that your Recoveries also increase the Allowance for Doubtful Accounts. Hence, they are recorded on the credit side of the T-Account.