

Financial Accounting

Module 6: Receivables and Revenue



Module Learning Outcomes

Describe the accounting and reporting of receivables and revenues

- 6.1: Recognize revenue received on account
- 6.2: Understand accounting for uncollectible accounts
- 6.3: Account for notes receivable
- 6.4: Describe the proper financial statement presentation of receivables

Revenue Recognition

Learning Outcomes: Revenue Recognition

6.1: Recognize revenue received on account

6.1.1: Summarize revenue recognition under GAAP

6.1.2: Demonstrate journal entries for sales and payments on account

Recognizing Revenue under the Accrual Basis

Cash Basis and Accrual Basis	
Cash Basis	Accrual Basis
Revenues are recognized as cash is received	Revenues are recognized when earned (goods are delivered or services are performed).
Expenses are recognized as cash is paid	Expenses are recognized when incurred to produce revenues

Recognizing Revenue under the Accrual Basis (cont.)

Five step process from FASB for Revenue Recognition:

1. Identify the contract with a customer.
2. Identify the performance obligation.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligation.
5. Recognize revenue when or as performance obligations are satisfied.



Journalizing Revenue and Payments on Account

6.7 THEORY OF CONTROL AND SUBSIDIARY ACCOUNTS

- What are the **advantages** and **disadvantages** of using **Control Accounts** and **Subsidiary Ledgers**

Advantages

- Using a control account removes unnecessary/bulky detail from the **General Ledger**
- This is because there is only **one account** in the **General Ledger** used to record the total of all debtors and creditors rather than **many ledgers**
- The **individual balance of each debtor and creditor** can be easily determined from their **Subsidiary Ledger**
- This assists the firm in its **decision-making** in choosing which accounts to follow up and pay

Practice Question 1

The ABC Lawn Service company in April collected \$10,000 as an advanced payment for lawn care services for the late spring and summer for its vacation properties that same year. As the accountant for ABC Lawn Service company, which account would you debit, and which account would you credit?

- A. Debit Checking, Credit Service Revenue
- B. Debit Unearned Revenue, Credit Accounts Payable
- C. Debit Service Revenue, Credit Cash
- D. Debit Checking, Credit Unearned Revenue

Uncollectible Accounts

Learning Outcomes: Uncollectible Accounts

6.2: Understand accounting for uncollectible accounts

6.2.1: Apply the direct write-off method of accounting for bad debts

6.2.2: Compute and journalize bad debt expense under the allowance method (percentage of sales)

6.2.3: Compute and journalize bad debt expense as a percentage of receivables (balance sheet method)

6.2.4: Prepare an accounts receivable aging analysis

6.2.5: Describe the process of factoring accounts receivable

Direct Write-Off of Bad Accounts

- There are two fundamental methods for handling these uncollectible accounts
 - **The direct write-off method** recognizes bad accounts as an expense at the point when judged to be uncollectible and is the required method for federal income tax purposes.
 - **The allowance method** comports better to the accrual basis of accounting by matching bad debt expense to revenue and is the accepted method to record uncollectible accounts for financial accounting purposes.



Direct Write-Off of Bad Accounts

Writing off a bad account when its uncollectibility is certain is called the direct write-off method.

JOURNAL				
Date	Description	Post. Ref.	Debit	Credit
20-				
Nov 30	Bad Debt Expense	550	2,000.00	
	Accounts Receivable	120		2,000.00
	To write off Our Town Properties receivable			

Estimating Bad Debt Expense

- The easiest, but least accurate way to do this is to simply take a percentage of sales, based on a historical average, and use it as an estimate, and then periodically make sure it is fairly accurate over time.
- The formula to estimate bad debts expense is:

Bad debt expense = Net sales (total or credit) × Percentage estimated as uncollectible

JOURNAL					Page 1
Date	Description	Post. Ref.	Debit	Credit	
20–					
Dec 31	Bad Debt Expense		10,000.00		
	Allowance for Doubtful Accounts			10,000.00	
	To record bad debts as a percentage of sales				

Estimating Uncollectible Accounts

Percentage-of-receivables method estimates uncollectible accounts by determining the estimated net realizable value of accounts receivable (many accountants refer to this as the balance-sheet method).

Accounts Receivable gross × estimated uncollectible = allowance

The image shows handwritten notes on a blackboard. At the top, it says "Receivables Method (%)" with a note "- BD expense" and "2012 AFDA". Below this, it lists: "End 2011 receivables = 500,000", "End 2012 receivables = 1,200,000", and "Percentage Uncollectible = 1%". To the right, there is a calculation: "5,000 beg" under "AFDA". A large, bold, green and white text overlay reads "PERCENTAGE OF RECEIVABLES METHOD". To the left of this overlay, there are labels: "Adj. BD", "A", "A/R", and "Net Sa". To the right, it says "+ realizable value of A/R". A small logo "Note Pirate.com" is visible in the top right corner of the blackboard area.

Accounts Receivable Aging Analysis

ADA

ADA	1,000
	<u>24,500</u>
	25,500

$1,000 + X = 25,500$

Bad Debt
Exp. 24,500

ADA 24,500

ADA

ADA	500
	<u>26,000</u>
	25,500

Bad Debt Exp 26,000

ADA 26,000

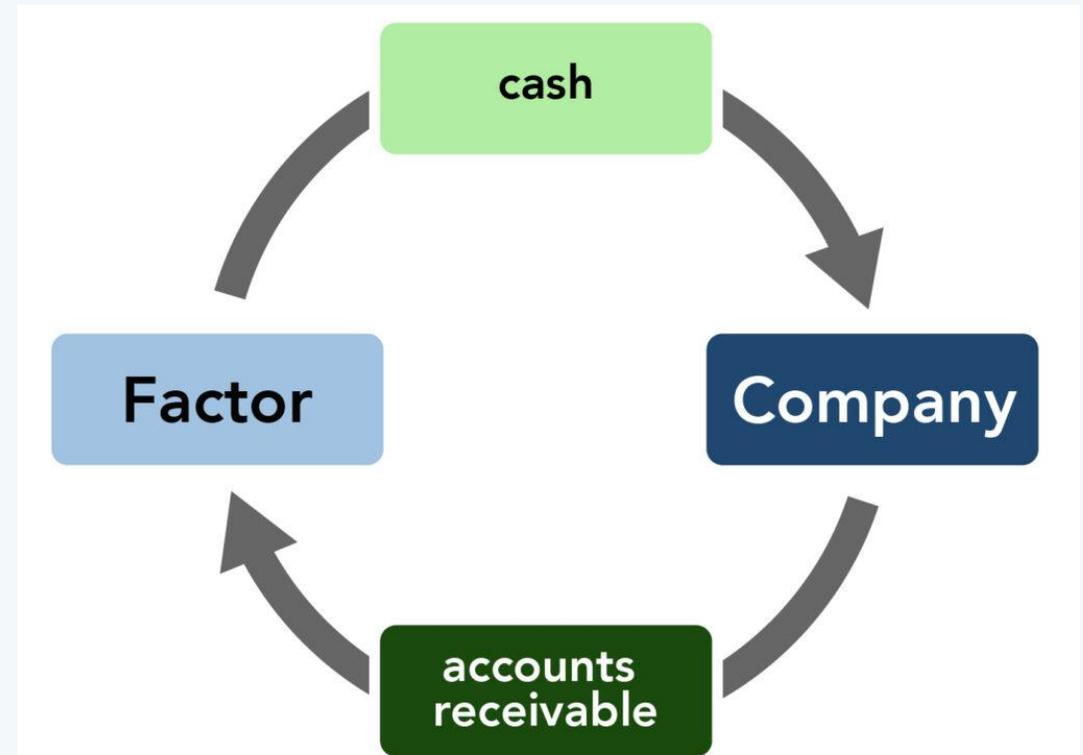
Factoring Accounts Receivable

- Accounts receivable factoring, also known as factoring, is a financial transaction in which a company sells its accounts receivable to a financing company that specializes in buying receivables at a discount. Accounts receivable factoring is also known as invoice factoring or accounts receivable financing
- The buyer (called the “factor”) collects payment on the receivables from the company’s customers.
- Companies choose factoring if they want to receive cash quickly rather than waiting for the duration of the credit terms. Factoring allows companies to immediately build up their cash flow and pay any outstanding obligations. Factoring helps companies free up capital tied up in accounts receivable and may also transfer the default risk associated with the receivables to the factor.

Factoring Accounts Receivable (cont.)

Factoring companies charge what is known as a “factoring fee.” The factoring fee is a percentage of the amount of receivables being factored. The rate charged by factoring companies depends on things like:

- The industry the company is in.
- The volume of receivables to be factored.
- The quality and creditworthiness of the company’s customers.
- Days outstanding in receivables (average days outstanding).



Notes Receivable

Learning Outcomes: Notes Receivable

6.3: Account for notes receivable

6.3.1: Explain the defining characteristics of a note receivable

6.3.2: Calculate and record accrued interest

6.3.3: Journalize collections on notes receivable

Recognizing Notes Receivable

A note receivable is evidenced by an actual written agreement, usually called a promissory note (promise to pay). The promissory note will include the parties to the transaction, the dollar amount borrowed, the interest rate, and the due date.

PROMISSORY NOTE

I, (Borrower) _____ agree and promise to pay the amount of (\$_____) to (Lender) _____ for value received at an annual interest rate of (%____).

First Payment Due Date (30 days after date of this promissory note) _____.

Final Payment Due Date (120 days after date of this promissory note) _____.

Witnessed by _____ Notary Public: (Seal)

City _____ State _____ Date _____

Accrued Interest Revenue

- **Interest** is the fee charged for use of money over a specific time period. To the maker of the note, or borrower, interest is an expense; to the payee of the note, or lender, interest is a revenue. A borrower incurs interest expense; a lender earns interest revenue. The basic formula for computing interest is:

Principal × Interest × Frequency of a Year

- **Principal** is the face value of the note. The interest rate is the annual stated interest rate on the note. Frequency of a year is the amount of time for the note and can be either days or months. We need the frequency of a year because the interest rate is an annual rate and we may not want interest for an entire year but just for the time period of the note.

Collecting Payments on Notes Receivable

At the maturity date of a note, the maker is responsible for the principal plus interest. The payee should record the interest earned and remove the note from its Notes Receivable account.

JOURNAL				
Date	Description	Post. Ref.	Debit	Credit
20-				
Jan 17	Checking Account		205,000.00	
	Note Receivable			200,000.00
	Interest Receivable			4,055.56
	Interest Revenue			944.44
	To record interest earned on note to HWC			

Practice Question 2

CutiePie candy company took out a 60 day note for \$100,000 at a 5% APR on November 1. Instead of waiting to pay off the note December 31, the company paid it off early on December 16. How much interest is due on the 60 day note (use 360 day year)?

- A. \$5,000
- B. \$625
- C. \$833
- D. \$611

Reporting Receivables on the Financial Statements

Learning Outcomes: Reporting Receivables on the Financial Statements

6.4: Describe the proper financial statement presentation of receivables

6.4.1: Demonstrate receivables as current and noncurrent assets

6.4.2: Recognize financial statement disclosures related to receivables

Financial Statement Presentation (cont.)

Statement 3 – Caterpillar, Inc. Consolidated Financial Position at December 31, (dollars in millions)		
Description	2019	2018
Assets		
Current Assets		
Cash and Short Term Investments	\$8,284	\$7,857
Receivables – Trade and other	8,568	8,802
Receivables – Finance	9,336	8,650
Prepaid expenses and other current assets	1,739	1,765
Inventories	11,266	11,529
Total Current Assets	39,193	38,603
Property, Plant and Equipment, net	12,904	13,574
Long-term receivables – trade and other	1,193	1,161
Long-term receivables – finance	12,651	13,286
Noncurrent deferred and refundable income taxes	1,411	1,439
Intangible assets	1,565	1,897
Goodwill	6,196	6,217
Other assets	3,340	2,332
	\$78,453	\$78,509

Disclosures

- In addition to the numbers on the income statement and the balance sheet, companies are required to disclose details in the notes that follow the financial statements, including things like:
 - Contracts with customers
 - Revenue recognized from contracts with customers
 - Disaggregated revenue into categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors
 - Contract balances for opening and closing balances of receivables, contract assets, and contract liabilities
 - Method(s) used to recognize revenue for performance obligations satisfied over time
 - Significant judgments, and changes in judgments, in applying the guidance
 - The timing of satisfying performance obligations
 - Determining the transaction price and allocating amounts to performance obligations
 - Any assets recognized from the costs to obtain or fulfill a contract with a customer

Quick Review

- What is revenue recognition under GAAP?
- How are sales and payments on account recorded in journal entries?
- How is the direct write-off method of accounting for bad debts applied?
- How does an accountant compute and journalize bad debt expense under the allowance method (percentage of sales)?
- How does an accountant compute and journalize bad debt expense as a percentage of receivables (balance sheet method)?
- How is an accounts receivable aging analysis prepared?
- What is the process of factoring accounts receivable?
- What are the defining characteristics of a note receivable?
- How is accrued interest calculated and recorded?
- How are collections on notes receivable journalized?
- When are receivables a current or a noncurrent asset?
- How are financial statement disclosures related to receivables?