AFA 100: Accounts Receivable & Bad Debt Expense

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What are Account Receivables?

An account receivable arises when there is a certain amount of money owed to a business for goods or services delivered but not yet paid for. Accounts receivable is an asset account on the balance sheet *(statement of financial position)* for a business who is entitled to receive the money because the amount owed can be converted into cash when you receive the money.

Accounts receivable can include payments due for services or sales provided..

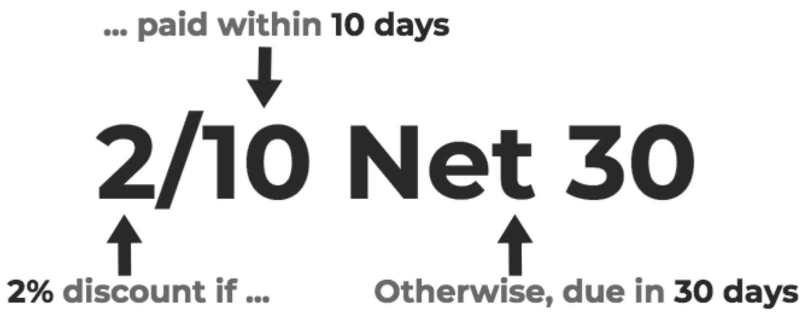
Example:
Assume you are in the furniture business. You have delivered furniture to a customer but you have not received the payment yet. In your books, this will be an accounts receivable because the customer will be paying you and you have an amount that is yet to be “received”.

Credit Sales and Credit Terms

Credit sales are a component of accounts receivable. These sales are often to encourage customers to purchase products without having to give up large sums of cash right away.

These kinds of sales often come with credit terms to encourage early payment. Below you can find a common example of credit terms and what each word signifies.

As you can see, if the customer pays within 10 days, they get a 2% discount. This incentivizes customers to pay early and ensures businesses get the money they are owed. However, if they do not pay in 10 days, they have a total of 30 days to pay but this will be without the 2% discount.



Reference: https://corporatefinanceinstitute.com/resources/accounting/2-10-net-30/

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What happens when a customer doesn't pay you the amount they owe?

Whenever there is an account receivable, there is a risk that customers may not pay you the amount that is due. These unpaid invoices cause losses to the business because they don't receive the money they are entitled to receive.

If the uncollectible amounts are likely and can be estimated, an account for uncollectible amounts must be estimated and recognized to ensure that the accounts receivable and net income are not overstated. This is done through an allowance for doubtful accounts (AFDA).

Allowance for Doubtful Accounts (AFDA)

An allowance for doubtful accounts (AFDA) helps you account for these risks and present a realistic picture of the accounts receivable on your balance sheet. This account is a contra-asset account to the accounts receivable which means it reduces the balance of your accounts receivable.

This account has an estimated balance of the amount that may not be collected during the year. This amount can be estimated based on industry averages or historical rates. At the end of each reporting period, businesses must calculate how much of the receivables they were supposed to receive were actually not collected. That amount is taken out of the AFDA and put into the **bad debt expense account.**

Bad Debt Expense

The bad debt expense account is an expense account on the income statement. This is considered an expense because the amount that the customer was supposed to pay now has to be paid by the business, consequently, the business has incurred an expense.

Methods to Calculate Bad Debt Expense

There are two methods allowed by IFRS to calculate bad debt expense:

1. **Percentage of Credit Sales Method**

For this method, the ending balance of the accounts receivable is multiplied by the percentage that management believes is uncollectable. This rate is also called the bad debt rate.

This method estimates that the amount uncollectible is a portion of the accounts receivable. Consequently, the estimated amount uncollectible is equal to the adjusted ending balance of the AFDA.

Example:

For example, assume that accounts receivable and the AFDA ending balances were $200,000 debit and $2,500 credit balances respectively at December 31, and the uncollectible accounts are estimated to be 4% of accounts receivable. This means that the AFDA adjusted ending balance is estimated to be the amount equal to 4% of $200,000, or $8,000 ***(4%*200,000)***.

The adjusting entry to achieve the correct AFDA adjusted ending balance of $8,000 would be:

Dr. Bad Debt Expense $5,500
Cr. Allowance for Doubtful Accounts $5,500

The AFDA ending balance after this entry would correctly be $8,000 ($2,500 unadjusted + $5,500 adjusting entry) which is equal to the amount calculated by multiplying the bad debt rate by the ending balance of the accounts receivable.

2. Aging of Accounts Receivable

This method categorizes accounts based on how long they have been outstanding. Typically, the longer the account has been due, the more likely it is to be uncollectible. For example, let's assume you lended money to your friend 5 years ago, there is now a lower chance that the friend will be paying you the money back.

Similar to the previous method, businesses will use past experiences to estimate the percentage of their outstanding receivables that will become uncollectible for each aged group. The most common age groups are 0-60 days, 90-120 days, more than 120 days outstanding.

The sum of all the estimated uncollectible amounts by group represents the total estimated uncollectible accounts. Just like the percentage of accounts receivable method previously discussed, the estimated amount of uncollectible accounts using this method is to be equal to the *ending balance of the AFDA account*. The adjusting entry amount must therefore be whatever amount is required to result in this ending balance.

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Example:

Brown Cow Dairy uses the aging approach to estimate bad debt expense. The balance of each account receivable is aged on the basis of three time periods as follows: (1) not yet due, $25,000; (2) up to 120 days past due, $10,000; and (3) more than 120 days past due, $5,000. Experience has shown that, for each age group, the average bad debt rates on the receivables at year-end due to uncollectibility are (1) 2 percent, (2) 10 percent, and (3) 30 percent, respectively. At December 31, 2020 (end of the current year), the allowance for doubtful accounts balance was $600 (credit) before the end-of-period adjusting entry was made.

Required:

What amount should be recorded as bad debt expense for the current year?

Aged Accounts Receivable	Amounts x	Estimated % uncollectible =	Estimated Amount Uncollectable
not yet due	$25,000	2%	$500
upto 120 days past due	$10,000	10%	$1,000
more than 120 days past due	$5,000	30%	$1,500
	estimated ending balance for AFDA		$3,000
	Unadjusted balance (opening balance)		$600
	Bad Debt Expense		**$2,400**

bad debt expense = estimated amount uncollectable - ending credit AFDA balance

Reference: McGraw Hill Libby Financial Account, 7th Canadian Edition, Qs E6-13

The adjusting entry to record the bad debt expense would be:

Dr. Bad Debt Expense $2,400
Cr. Allowance for Doubtful Accounts $2,400

Toronto Metropolitan University

Program Advising and Student Success
Ted Rogers School of Management, TRS 1-004
https://www.torontomu.ca/trsm-pass/

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