Accounts Receivable and Bad Debts

Do you often use your credit card to purchase goods or services? Have you ever wondered what transactions with a credit card actually look like from the vendor's point of view? Credit cards are a common way to make purchases **on account**. When customers pay on account, companies record that amount as a receivable. Receivables are **not** cash, but they are recorded on the asset side of the balance sheet because the company anticipates **receiving** that amount of cash from that customer in the future. On the balance sheet, receivables are recorded as "Current Assets" if they are due in less than a year, and as "Non-Current Assets" if due in a year or longer.

There are several types of Receivables, but in this session, we will focus on two common ones: **Accounts Receivable and Notes Receivable.**

So, how do we record a sale on account? If we recognize **sales revenue** with a **credit**, we usually debit cash to balance the entry. However, sales on account don't involve cash. Since we are not debiting cash, we **debit the accounts receivable account in its place**. For example, if a customer goes to LiliLime and purchases a pair of leggings with their credit card, the store does not receive cash for it straight away. Instead, they record a debit to Accounts Receivable on the date they recognize Sales Revenue, and credit Accounts Receivable once Cash is received, usually at the end of the month.

From the customer's perspective, when purchasing leggings from the clothing retailer, LiliLime, they are not actually paying in cash. Instead, they are paying **on account** - they have promised the store that they will pay off the amount at the end of the month, when they receive a credit statement.

However, everyone is probably familiar with broken promises, and although we hope that every single person will pay off their amount right away, there are people who end up not being able to pay. Their reasons may vary, from bankruptcy to debtor disappearance. Regardless, this unrecoverable debt from customers for the firm is referred to as "Bad Debt," and firms have a "Bad Debt Expense" account to recognize uncollectible debts. A common example of this is a borrower that doesn't pay back their loans from a bank.

Companies usually use the "**Allowance Method**" to record Bad Debt Expenses. They will estimate an uncollectible amount for each period, then record it as a **debit to Bad Debt Expense** and a **credit to Allowance for Doubtful Accounts.** The Allowance for Doubtful Accounts, or ADA account, is a contra-asset account that offsets the accounts receivable account. This reflects the accounting principle of **conservatism**, where we are on the side of caution in financial reporting and recognize that not all promises will be kept.

Then, when the amount is determined uncollectible, we debit the previously credited Allowance for Doubtful Accounts and Credit Accounts Receivable.

So out of all the accounts receivable on the sales to customers, the Net Realizable Value of Accounts Receivable is calculated by subtracting the ADA account from the total Accounts Receivable.

Bad debt expense is an income statement item, representing the amount of debt assumed to be uncollectible in the current period. ADA is a contra-asset account that keeps track of the total amount of debt that we believe is uncollectible, out of all the debt we are owed. It can be considered an account used to “write off” the amount that we assumed is “bad debt.” Therefore, **bad debt expense and ADA will not always match.**

But sometimes we do get lucky, and debts we’ve previously written off become collectible again. In this case, we reverse the journal entry used to write off their account by **crediting ADA and debiting accounts receivable for the amount recovered**, and then record the amount we collected as if nothing happened.

Let’s now look into how companies actually estimate the Bad Debt Expense for a period. There are two ways to determine the amount of Bad Debt Expense. The first method is the **Percentage of Credit Sales method**, where we **multiply the dollar amount of sales** we make on account by an **estimated percentage of uncollectible sales**. Pretend that LiliLime sold $1000 of leggings on account. If we expect 10% of credit sales to be bad debts, then we multiply $1000 by 10% to get a bad debt expense of $100.

The second is the **Aging of Accounts Receivable method**, where we estimate bad debt expense based on **how long accounts have remained unpaid**. If a customer keeps on telling us they will pay us next time every time we ask for a payment, then they’re probably not going to pay. Thus, we assume that **the longer an account remains unpaid, the less likely it will be paid off**.

We create a schedule that sorts our accounts receivable into buckets based on how long they have been overdue, with each bucket usually spanning thirty-day intervals. We then assign an estimated percentage of uncollectible sales to each bucket. For example, we can assume that 3% of accounts which are 1-30 days overdue are bad debts, while 25% of accounts which are more than 90 days overdue will be bad debts. We then multiply the amounts to get the estimated percent of bad debts for each bucket and sum these amounts to arrive at our ADA balance. The period’s bad debt expense then becomes the amount needed to adjust ADA to this new balance. This method requires professional judgment because every situation is different.

Ready for a question? Let’s look at a real-life example to understand how the journal entries look.

LiliLime estimated that 2% of its net credit sales will become uncollectible. If net credit sales for this year are $50,000, what is their estimated bad debt expense?

50,000 x 0.02 = 1,000

One of LiliLime’s B2B customers, GymWhale, goes bankrupt and is not able to pay for the clothes they purchased on account last month. LiliLime determines that \$5,000 will now become uncollectible, and writes off the \$5,000 Accounts Receivable in the following journal transaction.

Note that LiliLime has \$10,000 remaining in their Allowance for Doubtful Accounts.

Next month, a collection agency collected \$2,000 in Accounts Receivable for LiliLime that was previously written off. We reverse the write-off and record the partial collection like so:

Notice how we only reverse \$2,000 of the write off, because we were not able to recover the entire \$5,000 that we were owed.

Amazing! You now understand how to account for receivables and how to deal with accounts deemed uncollectible. Remember that there are other kinds of receivables like Notes Receivable, which are promissory notes representing a contractual right to receive cash. Such receivables are all assets to a company, and are the amount of money a business has to collect in cash in the future.