Chapter 8 Study Guide: Receivables, Bad Debt Expense, and Interest Revenue

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1. Introduction to Receivables

- **Receivables** are amounts owed to a company by customers or other entities. They arise from the sale of goods or services on credit.
- **Types of Receivables**:
  - **Accounts Receivable**: Amounts owed by customers for goods and services sold on credit.
  - **Notes Receivable**: Written promises to pay a certain amount of money on a specific date, usually with interest.
  - **Other Receivables**: Include loans to employees, advances to suppliers, and tax refunds.
- **Current vs. Noncurrent Receivables**:
  - **Current Receivables**: Expected to be collected within one year or within the company's operating cycle (whichever is longer).
  - **Noncurrent Receivables**: Receivables that will not be collected within the year.

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2. Recognizing and Reporting Receivables

- **Trade Receivables**: Amounts due from customers resulting from the sale of goods or services.
- **Nontrade Receivables**: Amounts due from other sources such as employees or tax refunds.
- Receivables are reported at **net realizable value (NRV)**, which is the amount the company expects to collect. This amount is adjusted for estimated **bad debts** (uncollectible accounts).

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3. Bad Debt Expense

- **Bad Debt Expense** is the amount a company estimates will not be collected from its accounts receivable.
- **Two Methods for Estimating Bad Debts**:
    1. **Percentage of Sales Method**: A percentage of total sales is estimated as uncollectible, and this amount is recorded as **Bad Debt Expense**.
    2. **Aging of Accounts Receivable Method**: The balance in the accounts receivable is classified by age, and a higher percentage of uncollectibility is applied to older accounts. This method focuses on the **Allowance for Doubtful Accounts**.
- **Allowance for Doubtful Accounts**: A contra-asset account that reduces the balance of accounts receivable to the amount expected to be collected (net realizable value).
- **Journal Entry for Bad Debt Expense**:
    - **Debit**: Bad Debt Expense
    - **Credit**: Allowance for Doubtful Accounts

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4. Writing off Uncollectible Accounts

- When it is determined that a specific account is uncollectible, the company writes off the account by:
    - **Debit**: Allowance for Doubtful Accounts
    - **Credit**: Accounts Receivable
- Writing off an account does not affect the income statement, as the expense was previously recognized when the allowance was created.

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5. Interest Revenue on Notes Receivable

- **Interest Revenue** is earned on notes receivable, and it is calculated based on the principal amount, interest rate, and time period.
- **Interest Calculation Formula**:

Interest = Principal x Interest Rate x Time/360

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    - **Principal**: The amount of the loan or note.
    - **Interest Rate**: The annual rate of interest.
    - **Time**: The time period for which the interest is calculated (usually in days or months).
- **Journal Entry for Interest Revenue**:
    - **Debit**: Notes Receivable (or Cash if interest is paid immediately)

- **Credit**: Interest Revenue

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6. Key Terms to Know

Practice Questions for Chapter 8: Receivables, Bad Debt Expense, and Interest Revenue

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1. Types of Receivables

Problem 1.1: Classifying Receivables

Classify each of the following as either **Accounts Receivable**, **Notes Receivable**, or **Other Receivables**:

- A customer promises to pay $1,000 in 30 days for services rendered.
- A company has a written promise to pay $5,000 in 90 days with an interest rate of 8%.
- The company lends $2,000 to an employee for a short-term loan.

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2. Calculating Bad Debt Expense Using Percentage of Sales Method

Problem 2.1: Percentage of Sales Method

ABC Corp. estimates that 2% of its total sales will be uncollectible. For the year, ABC Corp. made $500,000 in sales. Calculate the **Bad Debt Expense** for the year.

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3. Calculating Bad Debt Expense Using Aging of Accounts Receivable Method

Problem 3.1: Aging of Accounts Receivable Method

At the end of the year, XYZ Corp. has the following aged accounts receivable:

- 0-30 days: $80,000
- 31-60 days: $20,000
- 61-90 days: $10,000

- Over 90 days: $5,000

The company estimates that 1% of accounts that are 0-30 days old, 5% of accounts that are 31-60 days old, 10% of accounts that are 61-90 days old, and 20% of accounts that are over 90 days old will be uncollectible. Calculate the **total estimated bad debt**.

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4. Writing Off an Account

Problem 4.1: Writing Off Uncollectible Accounts

XYZ Corp. determines that a customer's account, which was previously $2,000, is uncollectible. What journal entry should the company make to write off the account?

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5. Calculating Interest Revenue on a Note Receivable

Problem 5.1: Calculating Interest Revenue

XYZ Corp. has a note receivable for $10,000 with an interest rate of 6% per year. If the note is for 90 days, calculate the **interest revenue** for the period.

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6. Journal Entry for Interest Revenue

Problem 6.1: Interest Revenue Journal Entry

XYZ Corp. receives interest of $600 on a note receivable that was issued 90 days ago. What is the correct journal entry for this transaction?

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7. Impact of Bad Debt on Financial Statements

Problem 7.1: Impact of Bad Debt

XYZ Corp. records bad debt expense of $5,000. How does this affect the following:

- Accounts Receivable
- Bad Debt Expense
- Net Income
- Allowance for Doubtful Accounts

Answers to Practice Questions

Problem 1.1: Classifying Receivables

- A customer promises to pay $1,000 in 30 days for services rendered → **Accounts Receivable**
- A company has a written promise to pay $5,000 in 90 days with an interest rate of 8% → **Notes Receivable**
- The company lends $2,000 to an employee for a short-term loan → **Other Receivables**

Problem 2.1: Percentage of Sales Method

- Sales = $500,000
- Estimated bad debt = 2% of sales
- **Bad Debt Expense** = 2% × $500,000 = **$10,000**

Problem 3.1: Aging of Accounts Receivable Method

- 0-30 days: $80,000 × 1% = $800
- 31-60 days: $20,000 × 5% = $1,000
- 61-90 days: $10,000 × 10% = $1,000
- Over 90 days: $5,000 × 20% = $1,000
- **Total Estimated Bad Debt** = $800 + $1,000 + $1,000 + $1,000 = **$3,800**

Problem 4.1: Writing Off Uncollectible Accounts

- **Journal Entry**:
  - **Debit**: Allowance for Doubtful Accounts $2,000
  - **Credit**: Accounts Receivable $2,000

Problem 5.1: Calculating Interest Revenue

- Principal = $10,000
- Interest Rate = 6%
- Time = 90 days / 360 days = 0.25

- **Interest Revenue** = \$10,000 × 6% × 0.25 = **\$150**

Problem 6.1: Interest Revenue Journal Entry

- **Journal Entry**:
  - **Debit**: Cash \$600
  - **Credit**: Interest Revenue \$600

Problem 7.1: Impact of Bad Debt

- **Accounts Receivable**: Decreases (due to the write-off)
- **Bad Debt Expense**: Increases (recognized in the period)
- **Net Income**: Decreases (because bad debt expense is an expense)
- **Allowance for Doubtful Accounts**: Increases (if adjusting) or decreases (if writing off an account)