

THEME: ACCOUNTANTS RECEIVABLE

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ACCOUNTING TERM: Accounts Receivable

A current asset owed to the company by customers when they purchase goods and services.

FEATURE ARTICLE: Working With Accounts Receivable

Deciding to extend credit to customers of your business means you need to be organized. This entails setting up an Accounts Receivable (A/R) system and consistently following all the policies and procedures established to make the system work. This is essential if you want to avoid the disappointing experience of making a sale only to find out later that you are not going receive compensation. For sure, there are going to be customers who flake out on their obligation to pay. However, equally certain is the fact that if you don't follow up in a timely manner with your outstanding A/R customers, you can expect to have many more uncollectible sales than you should have.

Let's take a look at the A/R system. First, you need to understand the five-step A/R formula. Step 1) You start with last month's ending A/R balance as your current month's beginning balance; Step 2) Add any new credit sales; Step 3) Subtract cash receipts from credit customers; Step 4) Add or subtract any adjustments that are necessary for a particular customer; Step 5) Total the first four steps to arrive at your new ending A/R balance.

1. Beginning A/R balance		_____
2. Increases (Sales)	(+)	_____
3. Decreases (Collections)	(-)	_____
4. Adjustments	(+ or -)	_____
5. Ending A/R balance		_____

The sequence of these five steps is what occurs in the A/R general ledger account each accounting period. The total A/R ending balance in step five is the figure that appears on the Accounts Receivable line of the Balance Sheet. The A/R general ledger account is called the "control account" and is a summary of all the A/R activity that occurred during the accounting period, such as, one month, quarter, or year.

The totals in the A/R control account should mirror the total of the individual A/R customer detail ledgers because the same five-step formula is used for each individual customer. The A/R control total on the Balance Sheet should be

compared to the customer detail ledger total as a proving step. If they are not the same, then you must find out why.

Your A/R software program will compute all this for you when you enter Sales and Cash Receipts. However, you have to enter any “adjustments”. This is the place where things can go haywire. Some of these adjustments can become quite convoluted and, to be recorded properly, they must be carefully thought out. In addition, you must become familiar with how to enter debit and credit memos in the A/R software program you are using. Issuing refunds, correcting mistakes, recording write-offs for bad debts, etc., can be tricky, especially if you don’t do it very often. You must prove your work each month and keep good notes, otherwise not only will your reports not match up, but your customers will get irritated when you try to collect a balance that is inaccurate.

After all the adjustments are made at the end of the accounting period, a report called the Accounts Receivable Aged Invoice Report should be run. This report tells you, by customer, how much is owed and how old the outstanding balance is. The total of this report should be the same amount found in the A/R control account on the Balance Sheet and in the Customer Detail report. If you use all three reports to prove your ending balances, and you take the time to clean up any discrepancies “as they arise”, your A/R system should always remain accurate.

QUESTION: How To Journalize Bad Debts?

Are you using an accrual method of accounting? Or, are you using a cash or hybrid (modified cash) method of accounting? It makes a difference. If you are using a strict accrual method of accounting and following Generally Accepted Accounting Principles (GAAP), then you must set up a contra (offset) account to Accounts Receivable called Reserve for Bad Debts or Allowance for Doubtful Accounts (ADA). Each month, or accounting period, an estimate of bad debts is made, based on a historical percentage of A/R, and is recorded as an expense to Bad Debts on the Profit & Loss Statement and to the ADA account on the Balance Sheet. By offsetting the amount in the ADA account against the A/R account you can more accurately determine the amount of receivables that will actually be collected. If your receivables are \$10,000 and your historical percentage of bad debts is five percent, then your bad debt estimate will be \$500. The journal entry would look like this:

DESCRIPTION	DEBIT	CREDIT
Bad Debt Expense	500.00	
Allowance Doubtful Accts		500.00

The ADA account accumulates all the estimated bad debt charges during the year. At the end of the year, the ADA balance should reflect only the historical

percentage of estimated bad debts. Therefore, an adjusting journal entry is usually made at the end of the year to clear the excess bad debts from the ADA account and apply the amount against the existing A/R balance. The process then begins again for the new year. The following is an example of the required journal entry if we assume that excess bad debts amounted to \$4,500.00:

DESCRIPTION	DEBIT	CREDIT
Allowance Doubtful Accts	4,500.00	
Accounts Receivable		4,500.00

However, in the U.S., the Internal Revenue Service no longer allows businesses to use the *allowance method*. It requires the *direct write-off method* for bad debts. This means that when you record a “bad debt expense” it must be because you have evidence that the account is uncollectible, such as proof that you have tried unsuccessfully to collect the debt. Businesses that use the hybrid method of accounting normally use the direct write-off method. Businesses using the cash method of accounting don’t have Accounts Receivable because they only record a sale when cash is received.

It is an arbitrary judgment whether an account receivable is determined to be uncollectible. Some businesses make the decision after ninety days, or after two collection attempts. Others wait longer.

TIP: Collecting Outstanding Receivables

The key to this process is information, organization, and consistency. You can use some A/R operating ratios to help provide information as to the quality of your receivables and how well collections are being handled. The following is an excerpt from my Accounting for Non-Accountants course regarding A/R ratios:

SALES/RECEIVABLES: (a turnover ratio)

Formula: Net sales divided by trade receivables (Accounts Receivable).

$$\frac{\text{Net Sales}}{\text{Trade Receivables}}$$

Meaning: Measures the number of times trade receivables turn over (are completely paid off) during the year. The higher the turnover of receivables, the shorter the time between sale and cash collection. For example, a company with sales of \$520,000 and receivables of \$104,000 would have a sales/receivables ratio of 5.0. which means receivables turn over five times a year. If a company’s receivables appear to be turning slower

than last year, or slower than the rest of the industry, then management should review its credit and collection policies.

Consideration: One problem with this ratio is that it compares one day's receivables, shown at the financial statement date, to total annual sales and does not take into consideration seasonal fluctuations. Averaging receivables can help counter this problem. Further, if cash sales are a significant part of total annual sales, then the ratio can be misleading.

Usefulness: Only useful if there are significant Accounts Receivables and the inherent problems are taken into consideration.

DAY'S RECEIVABLES:

Formula: The sales/receivables ratio divided into 365 (the number of days in one year)

$$\frac{365}{\text{Sales/Receivables}} \quad \text{or from the example above: } \frac{365}{5} = 73$$

Meaning: This figure expresses the average time, in days that receivables are outstanding. Generally, the greater number of days outstanding, the greater the probability of delinquencies in accounts receivable.

Consideration: A more accurate calculation would occur if only credit sales were used instead of total sales. This is because credit sales are more closely related to receivables than total sales.

Usefulness: If the company has accounts receivable, this ratio can provide a manager with a quick gage as to how the collections department is doing.

You will also need your A/R Ageing Report to determine which customers need to be contacted.

Organization includes an A/R invoicing system that will send out invoices indicating the amount due and any past due notices. Usually, a series of collection letters are sent asking for payment and warning that the account will go to a collection agency. If there is no response, a contact call must be made to find out what is going on. A pleasant and friendly voice works best; however it is essential to be firm and specific. The goal is to get a commitment to pay by a specific date. If payment is not received by the agreed upon date, then another

call must be made. It is still best to remain friendly, but very clear as to what the consequences will be for not paying.

Consistency means following up when you say you are going to and keeping a written record of all phone calls that includes to whom you spoke, what the agreement was, and the date payment is to be received. Going by memory does not work.

Often you will be able to tell which customers are sincere about paying and those that are not. The customers whom you feel are not going to pay need to be informed that their account will be sent to a collection agency which will adversely affect their credit standing. However, before, sending the account to collections, you can offer a discount. You know the old saying, "A bird in the hand is worth two in the bush". Or, if you feel that the customer will eventually be good for the amount owed, you can ask them to sign a formal note for the balance. This approach can serve as a test of their true commitment to pay, as a formal note can be more easily collected through the court system.

Calling customers to pay their bills is an unpleasant task at best. However, the worst thing you can do is to extend credit to customers and then not be prepared to follow up in the collection process. A hit and miss approach is going to cost you time and money and become nothing less than an exercise in frustration.

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