

12. Receivables

Types of receivables

- **Accounts receivable**: amounts due from customers for sale of goods or services performed on credit; also commonly referred to as debtors or trade debtors
- **Bills receivable**: a receivable evidenced by a formal written promise or order to pay
 - more formal arrangement than account receivable
 - mostly used for financing purposes
- Other receivables:
 - similar to accounts receivable but not related to goods or services

Accounts receivable

- Recognition
 - usually at time of sale
 - need to consider discounts and allowances
- Valuation
 - how to measure the value of accounts receivable for reporting purposes
 - not all amounts owing will be collected
 - need to account for estimate of amount that will become bad
- Control
 - assisting in the management and control of accounts receivable

Bad and doubtful debts

- **Bad debts expense**: the expense resulting when allowance is made for estimated uncollectable accounts
- Bad debts expenses are estimated at the end of the accounting period
- Risk of doing business on credit
- Minimised through credit checks
- Unpaid amounts represent a business expense
- Written off periodically
- Two methods to accounts for bad debts
 - allowance method
 - direct write-off method

Allowance method of accounting for bad debts

- **Allowance for doubtful debts**: the estimated amount of accounts receivable expected to be uncollected
- Estimate of doubtful debts made at the end of the period
- Adjusting entry recognises expense and a contra-asset
- Record the expense in same period as the income to which it relates
- 'Contra' current asset account
- AASB 137 *Provisions, Contingent Liabilities and Contingent Asset*
- In the balance sheet:
 - Current Assets
 - cash at bank
 - accounts receivable
 - **less: allowance for doubtful debts**

June 30	Bad Debts Expense	6 000	
	Allowance for Doubtful Debts		6 000
	(Estimated bad debts expense)		

Estimating doubtful debts

- Generally based on combination of
 - past experience
 - forecasts of future economic and business condition
- Involves considerable degree of judgement
- If doubtful debts are underestimated, results in an overstated income
- Two common methods
 - percentage of net credit sales
 - ageing of accounts receivable

Percentage of net credit sales

- **Percentage of net credit sales**: a method used to determine the amount of the allowance for doubtful debts
 - history of bad debts is analysed to establish relationship between credit sales and bad debts
- Income statement method
- GST is excluded from calculations
- Year-end adjustment to recognise bad debts expense

Ageing of accounts receivable

- **Ageing of accounts receivable:** the process of classifying accounts receivable on the basis of the length of time they have been outstanding and probability of collection; also a basis for determine the amount of the allowance for doubtful debts
 - based on length of time owing
 - older accounts statistically more likely to be bad
 - past accounting records analysed
- Calculates the amount the allowance for doubtful debts should be, ∴ what is recorded is an adjustment to the year end balance
- balance sheet method
- approach consistent with the *conceptual framework*
- Example
 - total estimate to become bad of \$5687 includes \$517(1/11) of GST which is excluded from the allowance
 - assume existing allowance is \$1540
 - top-up needed is \$1510 + \$1540 = 3630

Ageing of accounts receivable method

June 30	Doubtful Debts Expense	3 630	
	Allowance for Doubtful Debts		3 630
	(Bad debts expense for the year)		

Writing off bad debts

Jul 31	Allowance for Doubtful Debts	620	
	GST Collections	62	
	Accounts Receivable Control–J. Evans		682
	(Bad debts expense for the year)		

Writing off bad debts

- When debts are finally considered bad it is written off against the allowance
- Associated GST must also be removed
- Note both the control and subsidiary accounts must be credited

Recovery of an account written off

Nov 4	Accounts Receivable Control–J. Evans	275	
	GST Collections		25
	Bad Debts Recovered		250
	(Re-establish part account written off)		
	Cash at Bank	275	
	Accounts Receivable Control–J. Evans		275
	(Cash collection)		

Recovery of an account written off

- Need to reinstate sale
 - update subsidiary ledger and record cash receipt
- Recovery treated as revenue
 - income in income statement

Direct write-off method

- **Direct write-off method:** the recognition of bad debts expense at the time an account receivable is deemed to be uncollectable
 - no allowance for doubtful debts is made prior to write off

Direct write-off method

Jul 31	Bad Debts Expense	620	
	GST Collections	62	
	Accounts Receivable Control–J. Evans		682
	(Write-off of J. Evans account as bad)		

Management and control of accounts receivable

- Credit policies
 - credit department is responsible for investigating the credit history and determining the debt-paying ability of customers who apply for credit
- Monitoring credit policies
 - ageing analysis of receivables — finds out the age of individual customers' balances and identify those accounts that require the attention of the credit department
 - calculating and analysing appropriate ratios — ratios are used to assess credit control performance; receivable turnover and average collection period
- Internal control of accounts receivable
 - segregation of duties
- **Receivable turnover:** a ratio that measures the number of times average receivables are converted into cash during a period
- **Average collection period:** number of days taken to collect amounts due from receivables for credit sales

$$\text{Receivables Turnover} = \frac{\text{Net Credit Sales Revenue (income)}}{\text{Average Receivables}}$$

$$\text{Average Collection Period} = \frac{365 \text{ days}}{\text{Receivables Turnover}}$$

Disposal of accounts receivable

- **Factoring:** the selling (purchase) of accounts receivable to (by) a factor business
- Factor: a business or financial institution that buys accounts receivable for a fee, and then collects the cash from those accounts (the receivables)
- **Credit card:** a card that enables the holder to obtain credit up to a predetermined limit from the issuer of the card for the purchase of goods and services
- **Debit card:** a card used in the electronic funds transfer point of sale (EFTPOS) system, where funds are debited to the card user's account at the bank and transferred instantaneously to the credit of the account of the seller of the goods or services
- Sale of accounts receivable

- also known as factoring
- realise cash to finance trading/other activities
- minimise costs of credit control
- Use of credit cards
 - transfers the detailed accounting for and collection of receivables to the issuer of the card
- Use of debit cards
 - EFTPOS - very prevalent
 - Immediate transfer from customer account to business account
 - Efficiently a cash sale

Bills receivable

- **Bills receivable**: a receivable evidenced by a formal written promise or order to pay
 - more formal arrangement than account receivable
 - a bill of exchange and promissory note is made
- **Bill of exchange**: an unconditional order in writing, addressed by one person or entity to another, requiring the person or entity to whom it is addressed to pay a certain sum of money to a designated person on a determinable future date
 - trade bills
- **Promissory note**: an unconditional written promise to pay a sum certain in money on demand or at a future determinable date
 - there must be an unconditional promise in writing
 - it must involve two parties — the maker and the payee
 - it must be signed by the maker
 - it must specify the sum of money to be paid on demand or on a specified date
- **Interest**: a charge made for the use of money calculated as principal x rate x time
 - To the payee [person who receives the money], interest is revenue
 - To the acceptor of a bill or maker of a note, interest is an expense
- **Maturity value**: the amount of a bill due on its maturate date; it includes principal as well as interest
- **Principle**: the base figure (face amount) of an amount owing (a bill)

Example — accounting for receipt of bill receivable

- Receipt of bill in settlement of overdue account receivable from D. Mead
- \$1500, 90 day bill at 15% interest
 - interest = principal x rate x time/365
- Receipt of cash on payment of the note by the debtor at maturity date

Jul 9	Bills Receivable	1 555.48	
	Accounts Receivable – D. Mead		1 500.00
	Unearned Interest Income		55.48
	(Receipt of a note in settlement of an account receivable)		
	[Interest = \$1500 x 0.15 x 90/365]		

End of period adjustments for interest revenue

- Interest is earned as time passes
- As the term of the note expires, the unearned interest becomes interest revenue
- Adjusting entries may be necessary at end of reporting period to give recognition of interest revenue up to that date

13. Inventories

Determining the cost of inventory on hand

- Stocktakes
 - periodic inventory system — necessary to determine ending inventory and cost of sales
 - perpetual inventory system — used to verify accounting records, identifies loss, theft or deterioration
- Transfer of ownership
 - EXW (freight paid by buyer)
 - DDP (freight paid by seller)
- Goods on consignment
 - agreement where 'agent' sells goods on behalf of owner for a commission
- The cost of inventory (including all direct and indirect costs)
 - purchase costs
 - conversion costs
 - other costs
 - excludes wages, storage, administration, selling and distribution costs etc

Assignment of cost to ending inventory and cost of sales

- Four methods of inventory cost assignment
- **Specific identification:** an inventory costing method by which the cost of a specific item sold can be separately identified from the cost of other units held in the inventory
- **First-in, first-out (FIFO):** a cost flow assumption in inventory costing that assumes the first units purchased were the first units sold. The cost of ending inventory is assumed to be the cost of the most recently purchased units
 - FIFO has the highest gross profit because prices go up
- **Last-in, last-out (LIFO):** a cost flow assumption in inventory costing that assumes the most recent units purchased were the first units sold. The cost of ending inventory is assumed to be the cost of the earliest units purchased
 - method is based on the assumption that the cost of the last units acquired is the cost of the first units sold
 - not used in Australia
- **Averaging cost:** an inventory costing method in which an average unit cost is calculated by dividing the total cost of goods available for sale by the total number of units available for sale
 - method calculates an average cost per unit and uses this to cost the ending inventory
 - weighted average (periodic method)
 - moving average (perpetual method)
- All profits will end up the same because eventually all assets will be consumed with total costs being equal

Comparison of costing methods

Sales revenue	\$360	\$360	\$360	\$360
Beginning Inventory	100	100	100	100
Add: Purchases	312	312	312	312
Goods available for sale	412	412	412	412
Less: Ending inventory	210	224	199	212
Cost of sales	202	188	213	200
Gross profit	158	172	147	160
Less: Expenses	120	120	120	120
Profit	\$ 38	\$ 52	\$ 27	\$ 40
Ending inventory reported	\$210	\$ 224	\$199	\$212

Comparison of costing methods

- Specific ID
 - consistent with actual movement of the inventory
 - offers room for manipulating profit
- FIFO
 - reflects current prices in ending inventory
 - does not permit manipulation of profit
- LIFO
 - results in matching current COS with current revenue
 - balance sheet values become out-dated
 - profits can be manipulated
- Weighted average
 - results in identical items being assigned the same value
 - tends to smooth out profit and inventory values
- Which method to select
 - entity should choose based on a range of factors
 - ideally specific identification 'LIFO' not allowed under the accounting standards
- Consistency
 - need to be consistent
 - must use the same accounting methods and procedures from period to period

Costing methods in the perpetual inventory system

- Inventory record maintained for each item of inventory
- Inventory control account maintained in the general ledger
- Inventory records collectively constitute the inventory subsidiary ledger

- Provides continuous record of transactions
- **Moving average**: an inventory costing method by which an average unit cost is calculated after each purchase. The method applies only where a perpetual inventory system is being used
 - $\text{cost of goods available for sale currently} / \text{total number of units available for sale currently} = \text{moving average cost}$

Comparison of inventory systems

- When the period and perpetual systems are compared
 - specific identification and FIFO methods will give the same cost of sales and ending inventory under each system
 - LIFO and average cost methods will give different cost of sales and inventory figures under each system
 - timing of calculation of COS

The lower of cost and net realisable value rule

- **Lowering of cost and net realisable value**: inventory valuation method where inventory is valued at lower of original cost and net realisable value at the end of the reporting period
- **Net realisable value**: the market value based on estimated proceeds of sales less, where applicable, GST and all further costs of production, marketing, selling and distribution to customers
- Simple rule - the name is the rule
- Accounting standards require inventories to be valued at the lower of cost and net realisable value
 - net realisable value is the estimated selling price in the normal course of business less the estimated costs of sale

Sales returns and purchase returns

- Perpetual inventory system (no record for periodic)
- Recorded as negative entry in appropriate column
 - sales return is a negative sale
 - purchases return is a negative purchase
- FIFO
 - purchase returns recorded at price negotiated with supplier
 - sales returns are brought in at the latest price attached to the relevant sale
- Moving average
 - purchase returns recorded at price negotiated with supplier

Inventory errors

- Perpetual inventory
 - physical stock-take made to confirm perpetual records
 - difference may be due to theft, damage or inaccurate recording
 - goods in transit
 - cut-offs
- Periodic inventory
 - counting and pricing errors

Estimating inventories

- Two methods
 - retail inventory method
 - gross method
- Need to estimate inventory when full count is inappropriate
 - monthly reporting
 - destruction of records
 - as a reasonable check
 - to detect theft

Retail inventory method

- **Retail inventory method**: a method used to estimate the ending inventory value based on the relationship of cost to retail processes (excluding GST)
- Used by businesses in the retail environment
 - for interim reporting
 - in lieu of stock take
- Need to maintain records of the following:
 - beginning inventory at cost and retail
 - purchases at cost and retail sales for each month

Retail Inventory method

- Estimate ending inventory as follows:

$$\text{COGAS (retail and cost)} = \text{beginning inventory} + \text{purchases}$$

$$\text{Ending inventory at retail} = \text{COGAS (retail)} - \text{net sales}$$

$$\begin{aligned} \text{Ending inventory at cost} &= \text{ending inventory at retail} \times \text{ratio of cost to retail} \\ &= \text{COGAS (cost)} / \text{COGAS (retail)} \end{aligned}$$

Gross profit method

- **Gross profit method**: a method used to estimate ending inventory value based on the assumption that the gross profit percentage is approximately the same from period to period
 - assumes that: the rate at which gross profit earned in the year previous year is the same for current year
- **Gross profit**: net sales less cost of sales
- Historical position applied to current period
- Example
 - $\text{Gross profit} = \text{net sales} - \text{COS}$
 - Net sales = 100%
 - GP rate = 40%
 - $\text{COS} = 60\%$
- Once the gross profit percentage is known, ending inventory can be estimated as follows:
 - determine COGAS
 - estimate gross profit using GP% from previous periods
 - determine estimated COS by deducting Gross Profit from sales
 - deduct COS from COGAS to determine estimated ending inventory

Presentation in financial statements

- AASB 102 inventories
 - disclose suitable subclassifications (relevant to activities)
 - valuation basis must also be disclosed for each

Effect of costing methods on discussion making

- As previously discussed, there are 2 key ratios
 1. gross profit ration
 2. profit margin
 3. inventory
- Ratios will be changed by inventory costing method
- Users must take into account different methods when comparing activities