

Trade Receivables Allowance for doubtful debts

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Trade Receivables

Allowance for doubtful debts

- Relevant Accounting Standards
- Expense Recognition Principle
- The Accounting Cycle
- Journal Entries for Trade Receivables
- Valuation of Trade Receivables
- Allowance Method
- Adjusting Entries (2nd Approach)
- 1st Approach
- Comparison of the 2nd Approach and 1st Approach

Relevant Accounting Standards

- A contractual right to receive cash is a Financial Asset (HKAS 32)
- An asset is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. (Conceptual framework)
- An entity shall recognize a loss allowance for expected credit losses on a financial asset (HKFRS 9)
- An entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables that result from transactions that are within the scope of HKFRS 15. (HKFRS 9)

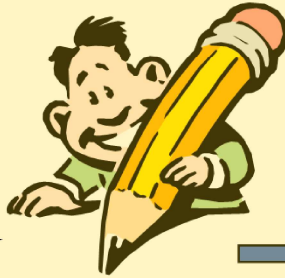
Expense Recognition (Matching) Principle

- Match expenses with revenues in the period when the company makes efforts to generate those revenues.

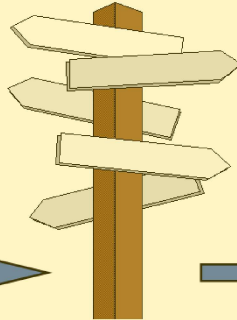
The Accounting Cycle



Analyze
business
Transactions
(1)



Journalize
transactions.
(2)



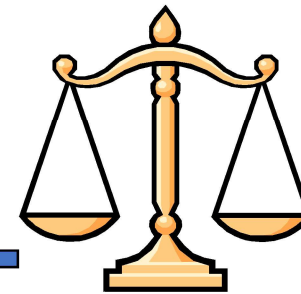
Post entries to the
ledger
accounts.
(3)



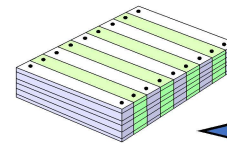
Prepare trial
balance.
(4)



Make end-of-
period/year
adjustments.
(5)



Prepare adjusted
trial balance.
(6)



Prepare
financial
statements.
(7)



Prepare a post
closing trial balance
(9)



Journalize and
post closing entries
(8)

Journal Entries for Trade Receivables

Date	Description	Debit (\$)	Credit (\$)
Dec 1	Trade Receivables – SC Company	10,000	
	Sales		10,000
Dec 3	Sales Returns	1,000	
	Trade Receivables – SC Company		1,000
Dec 10	Cash/Bank	9,000	
	Trade Receivables – SC Company		9,000

Valuation of Trade Receivables

Allowance for doubtful accounts (Contra asset account)

Allowance Method

- Losses are estimated before actual write off
- Better matching
- Trade Receivables stated at cash realizable value
- Required by IFRS.
- Expected credit loss

1. Estimate how much of the trade receivables is not collectible (Allowance for doubtful accounts ending balance)
 2. Comparing the required ending balance with the existing balance to prepare the adjusting entries at the end of the period/year
 - Dr Bad debts expenses
 - Cr Allowance for doubtful accounts
 - (required ending balance – existing balance)
- Trade Receivables - Allowance for doubtful accounts ending balance = Net Trade Receivables (presented in the Statement of Financial Position)
 - During the period/year, when there is actual amount to be written off
 - Dr Allowance for doubtful accounts
 - Cr Trade Receivables
 - (Do not debit the bad debt expense account, since the bad debt expense was estimated and accounted for)
 - If money collected back after written off
 - Dr Trade Receivables
 - Cr Allowance for doubtful accounts
 - Dr Cash/Bank
 - Cr Trade Receivables

Allowance Method (2nd Approach)

- Estimate 'uncollectible' accounts (the ending balance of allowance for doubtful accounts) and record the movement of allowance for doubtful accounts at the end of each period.
- For 'matching' purpose, bad debt expense should be recorded in the same accounting period in which the sales related to the 'uncollectible' accounts (impairment of trade receivables) were recorded.
- The adjusting entry to record the movement of the allowance for doubtful accounts in order to arrive the estimated uncollectibles (ending balance of the allowance for doubtful accounts) at the end of the period:

Date		Account Titles and Explanation	Debit	Credit
20X1		Bad debts expenses	2,880	
Dec	31	Allowance for doubtful accounts		2,880
		<i>To record estimated uncollectible account</i>		

← Movement of the allowance for doubtful accounts

Allowance Method(2nd Approach): Percentage-of-receivable

● **Percentage-of-receivable(this method is consistent with IFRS)**

- Emphasis on Realizable Value
- Matching Trade Receivables with Allowance for Doubtful accounts

JW Limited Statement of Financial Position December 31, 20X1 (partial)			
Current assets			
Cash			\$14,800
Trade Receivables	\$86,300		
Less: Allowance for doubtful accounts	3,390		82,910
Merchandise inventory			160,000
Prepayments			15,000
Total current assets			272,710

Contra asset account of T/R →

→

Cash realizable value: the net amount of trade receivables that the business expects to collect (i.e. converted into cash).

Allowance Method(2nd Approach): Percentage-of-receivable

%-of-receivables (Statement of Financial Position Approach)

- Use the historical relationship between trade receivables and bad debt expenses and credit loss forecasting factors (senior management estimates the amount)
- The **multiple rates** (known as **aging of receivables**), are applied to the trade receivables to determine the **desired balance** in the **Allowance for Doubtful Accounts**.
- Bad Debts Expenses: the **adjustment** necessary to bring the Allowance account to its desired ending balance.

1. Estimate the **Allowance for Doubtful (Uncollectible) Accounts** balance:
Year-end Trade Receivables x Estimated Uncollectible %
2. **Bad Debts Expenses:**

Estimated Adjusted Balance in Allowance for Doubtful Accounts

Opening Balance in Allowance for Doubtful Accounts

-

= Estimated Bad Debts Expenses

Allowance Method (2nd Approach): Percentage-of-receivable (Aging of receivables)

Dec.31, 20X1, the receivables for JW Limited were as follows:

Customer	Balance	Not Past Due	Days Past Due					
			1-30	31-60	61-90	91-180	181-365	over 365
ABC & Co.	\$ 150			\$ 150				
BBK & Co	610					\$ 350	\$260	
FIE & Co.	470	\$ 470						
Saxon Woods	160							160
Total	\$86,300	\$75,000	\$4,000	\$3,100	\$1,900	\$1,200	\$800	\$300

Uncollectibles %

2% 5% 10% 20% 30% 50% 80%

Allowance Method(2nd Approach): Percentage-of-receivable (Aging of receivables)

Customer	Balance	Not Past Due	Days Past Due					
			1-30	31-60	61-90	91-180	181-365	over 365
ABC & Co.	\$ 150			\$ 150				
BBK & Co.	610					\$ 350	\$260	
FIE & Co.	470	\$ 470						
<hr style="border-top: 1px dashed yellow;"/>								
Saxon Woods	160							160
Total	\$86,300	\$75,000	\$4,000	\$3,100	\$1,900	\$1,200	\$800	\$300

Uncollectibles PERCENT								
	2%	5%	10%	20%	30%	50%	80%	
AMOUNT	\$3,390	= \$1,500	\$200	\$310	\$380	\$360	\$400	\$240

Desired/required ending balance

Allowance Method (2nd Approach): Percentage-of-receivable

General Ledger	
Trade Receivables	
Bal	86,300
Allowance for Doubtful Acct.	
Bal c/f	3,390
Bal b/f	510
	Bad Debts
	2,880
Bad Debts Expenses	
Allowance for Doubtful Acct	2,880

Unadjusted credit balance in
“allowance account”: \$510

Desired balance: **\$3,390**

Statement of Fin. Position

Trade receivables	\$86,300
Less: Allowance for doubtful accounts	3,390
Net realizable value	\$82,910

Date	Account Titles and Explanation	Debit	Credit
20X1	Bad debts expenses (\$3,390 - 510)	2,880	
Dec 31	Allowance for doubtful accounts		2,880

Allowance Method (2nd Approach): Actual write off of bad debts

- The General Manager of JW Limited authorized a write-off of the \$160 balance owed by Saxon Woods on Jan 20, 20X2:

Date		Account Titles and Explanation	Debit	Credit
20X2		Allowance for doubtful accounts	160	
Jan	20	Trade Receivables - Saxon Woods		160
		<i>To write off an uncollectible account</i>		

Note: Bad Debts Expenses *are not* debited

The actual write-off entry for \$160 does not reduce net receivables:

	<u>Before</u>	<u>After</u>
Trade Receivables	\$86,300	\$86,140
Less: Allowance for Doubtful Accounts	<u>3,390</u>	<u>3,230</u>
Net Receivables	<u>\$82,910</u>	<u>\$82,910</u>

Allowance Method (2nd Approach): Later Collection on Written-off Bad Debts

- On Feb. 26, 20X2, Saxon Woods paid the \$120 amount that JW Limited had written off on Jan. 20:

Note: Before the payment entry, the debt must be restored.

1

Date	Account Titles and Explanation	Debit	Credit
20X2	Trade Receivables - Saxon Woods	120	
Feb 26	Allowance for doubtful accounts		120
	<i>To reverse the entry made to write off the accounts</i>		

2

Date	Account Titles and Explanation	Debit	Credit
20X2	Cash	120	
Feb 26	Trade Receivables - Saxon Woods		120
	<i>To record collection of the account.</i>		

Allowance Method: Percentage-of-receivable

- **Percentage-of-receivable (this method is consistent with IFRS)**

- Emphasis on Realizable Value
- Matching Trade Receivables with Allowance for Doubtful accounts

JW Limited			
Statement of Financial Position			
December 31, 20X2 (partial)			
Current assets			
	Cash		\$15,800
	Trade Receivables	\$114,300	
Contra asset account of T/R	Less: Allowance for doubtful accounts	4,590	109,710
	Merchandise inventory		200,000
	Prepayments		16,000
	Total current assets		341,510

Cash realizable value: the net amount of trade receivables that the business expects to collect (i.e. converted into cash).

2nd Approach

Adjusting entries for Allowance for doubtful accounts

Estimated Adjusted Balance in Allowance for Doubtful Accounts

Opening Balance in Allowance for Doubtful Accounts

= Estimated Bad Debts Expenses

Estimated Adjusted Balance : \$4,590
 Unadjusted Balance : 3390 – (160 -120) = 3,350
 Estimated Bad Debts Expenses : \$1,240

Allowance for doubtful accounts

TR	160	Bal b/f	3,390
Bal c/f	4,590	TR	120
		Bad Debts	1,240
	4,750		4,750

Adjusting

JW Limited Statement of Financial Position December 31, 20X2(partial)			
Current assets			
Cash			\$15,800
Trade Receivables	\$114,300		
Less: Allowance for doubtful accounts	4,590		109,710
Merchandise inventory			200,000
Prepayments			16,000
Total current assets			341,510

Cash realizable value: the net amount of trade receivables that the business expects to collect (i.e. converted into cash).

Allowance Method (2nd Approach): Actual write off of bad debts

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	To write off an uncollectible account		

Note: Bad Debts Expenses *are not* debited

Allowance Method (2nd Approach): Later Collection on Written-off Bad Debts

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Date	Account Titles and Explanation	Debit	Credit
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Feb 26	Allowance for doubtful accounts		120
	To reverse the entry made to write off the accounts		

1st Approach: Actual write off of bad debts

- The General Manager of JW Limited authorized a write-off of the \$160 balance owed by Saxon Woods on Jan 20, 20X2:

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Note: Bad Debt Expenses *are* debited

1st Approach: Later Collection on Written-off Bad Debts

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20X2		Trade Receivables - Saxon Woods	120	
Feb	26	Bad debts expenses		120
		<i>To reverse the entry made to write off the accounts</i>		

2

Date		Account Titles and Explanation	Debit	Credit
20X2		Cash	120	
Feb	26	Trade Receivables - Saxon Woods		120
		<i>To record collection of the account.</i>		

1st Approach

Adjusting entries for Allowance for doubtful accounts

Estimated Adjusted Balance :	\$4,590
Opening Balance :	<u>\$3,390</u>
Estimated Allowance for doubtful accounts :	<u><u>\$1,200</u></u>

Allowance for doubtful accounts			
Bal c/f	4,590	Bal b/f	3,390
		Profit and Loss	1,200
	4,590		4,590

← Adjusting

Profit and Loss account expenses items	
Bad debts expenses (160-120)	40*
Increase in Allowance for doubtful accounts	<u>1,200</u>
Total impact	<u>1,240</u>

JW Limited Statement of Financial Position December 31, 20X2(partial)			
Current assets			
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Less: Allowance for doubtful accounts	4,590		109,710
Merchandise inventory			200,000
Prepayments			16,000
Total current assets			<u>341,510</u>

Contra account of T/R

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1st Approach: Actual write off of bad debts

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Feb 26	Bad debts expenses		120
	To reverse the entry made to write off the accounts		

Comparison of the 2nd Approach and 1st Approach

1 st Approach	2 nd Approach
<u>Actual write-off of trade receivables</u>	
Dr Bad debts expenses Cr Trade receivables	Dr Allowance for doubtful accounts Cr Trade receivables
<u>Bad debts recovery</u>	
Dr Trade receivables Cr Bad debts recovered	Dr Trade receivables Cr Allowance for doubtful accounts
Dr Cash/Bank Cr Trade receivables	Dr Cash/Bank Cr Trade receivables
<u>Bad debts estimate at financial year end</u>	
Dr Profit and loss Cr Allowance for doubtful accounts	Dr Bad debts expenses Cr Allowance for doubtful accounts

Reasons for changing to the 2nd approach:

- more popular use in reality
- more concise: one item relating to bad debts in income statement
- consistent with the HKFRS 9 -An entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables that result from transactions that are within the scope of HKFRS 15
- users of the financial statements have a better understanding of the financial position of the company for making their economic decisions²¹