TRADE

TRADE RECEIVABLES, IRRECOVERABLE DEBTS AND ALLOWANCES FOR RECEIVABLES

THE TOTAL VALUE OF TRADE RECEIVABLES FOR A BUSINESS AT ANY ONE TIME REPRESENTS THE AMOUNT OF SALES WHICH HAVE NOT YET BEEN PAID FOR BY CUSTOMERS.

Trade receivables arise when a business makes sales or provides a service on credit. For example, if Ben sells goods on credit to Candar, Candar will take delivery of the goods and receive an invoice from Ben. This will state how much must be paid for the goods and the deadline for payment, eg within 30 days. Ben now has a trade receivable – the amount payable to him by Candar.

The total value of trade receivables for a business at any one time represents the amount of sales which have not yet been paid for by customers. The trade receivables figure will depend on the following:

1 The value of credit sales. The greater the value of credit sales then, other things being equal, the greater the total of trade receivables.
2 The period of credit given. The longer the period of credit given to customers then, other things being equal, the greater the total of trade receivables.
3 The efficiency with which the business administers its trade receivables. The more inefficient the business is in billing its customers and collecting overdue accounts then, other things being equal, the greater the total of trade receivables.

RECORDING THE CREDIT SALE

Let's imagine that Ingrid makes a credit sale of $6,450 to Manfredi. The sale was made on 17 March 2010 and the goods have been delivered to Manfredi along with an invoice for $6,450. The invoice states that the amount owing should be paid within 30 days from the date of the invoice.

The invoice will be processed through Ingrid's accounting system. The original entry will be in Ingrid's Sales Day Book which lists all credit sales chronologically. Total credit sales (including the $6,450) will be posted from the Sales Day Book to the debit of trade receivables account and the credit of sales account – both accounts being in the General Ledger. The $6,450 will also be posted to the debit of a personal account opened for Manfredi and kept in the Receivables Ledger.

In a computerised accounting system, all these accounting entries and the production of the invoice would take place simultaneously.

Manfredi's account will look something like **Table 1** below in the Receivables Ledger.

Manfredi's account shows a debit balance. This is an asset because it 'is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity' (IASB *Framework for the Preparation and Presentation of Financial Statements*, paragraph 40).

Here the 'entity' is Ingrid's business, the 'past event' is the sale, and the 'future economic benefits' are represented by the cash received from Manfredi when he settles the invoice.

TABLE 1: MANFREDI'S ACCOUNT IN THE RECEIVABLES LEDGER

Manfredi					
2010		**$**	**2010**		**$**
17 Mar	Sales	6,450			

Studying Paper F3?
Performance objectives 10 and 11 are relevant to this exam

RECEIVABLES

RELEVANT TO ACCA QUALIFICATION PAPER F3 AND CAT PAPERS 1, 3 AND 6

The debit balance is also a current asset because it meets the criteria in paragraph 66 of IAS 1, *Presentation of Financial Statements*. This states that an entity should classify an asset as current when any one of the following applies:

(a) The entity expects to realise the asset, or intends to sell or consume it, in its normal operating cycle.
(b) The entity holds the asset primarily for the purpose of trading.
(c) The entity expects to realise the asset within 12 months after the reporting period.
(d) The asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

In this example, the asset meets criterion (c) because the amount is payable within 30 days, and also criterion (a) because Ingrid's normal operating cycle is buying and selling on credit, collecting cash from customers, and paying suppliers.

The effect on the accounting equation is that inventory will decrease by the cost of the goods sold and receivables will increase by the selling price of the goods sold. So total assets increase by the profit made on the sale. This also increases capital/equity. There is no change in liabilities.

The profit on this transaction is therefore taken when the goods are sold even though no money has exchanged hands yet. This is because this transaction meets all of the recognition rules in paragraph 14 of IAS 18:

(a) The entity has transferred to the buyer the significant risks and rewards of ownership of the goods.
(b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership, nor effective control over the goods sold.
(c) The amount of revenue can be measured reliably.
(d) It is probable that the economic benefits associated with the transaction will flow to the entity.
(e) The costs incurred, or to be incurred, in respect of the transaction can be measured reliably.

All these criteria are met here:

- Manfredi now possesses and controls the goods (criterion (a)) and Ingrid doesn't (criterion (b))
- Manfredi has agreed the price (as per the invoice), meeting criterion (c)
- Manfredi is likely to pay the invoice (Ingrid wouldn't have sold to Manfredi otherwise, and can sue for payment if necessary) (criterion (d))
- Ingrid's costs of buying and selling the goods are measurable (criterion (e)).

What happens now?

If all goes well, Manfredi will keep to the terms of the agreement and Ingrid will receive payment within 30 days. If Manfredi pays on 16 April 2010, Ingrid will debit this in her Cash Book (in the Bank column) and credit the trade receivables account (in the General Ledger). The payment will also be credited to Manfredi's account in the Receivables Ledger, as shown in **Table 2** below.

This now completes the transaction cycle. The asset trade receivables reduces by the amount of the payment, and cash at bank increases by the same amount.

ENCOURAGING PROMPT PAYMENT

Sometimes the invoice will state that a cash discount can be taken if full payment is received by a certain date. This is to encourage prompt payment by the customer. For example, let's suppose that the invoice issued to Manfredi stated that a 2% discount can be deducted if the invoice is paid within 15 days – half the normal period of credit. Let's suppose that Manfredi takes this offer up and pays on 30 March. The payment will be recorded in Manfredi's account as shown in **Table 3** on **page 3**.

TABLE 2: MANFREDI'S ACCOUNT IN THE RECEIVABLES LEDGER (POST-PAYMENT)

Manfredi

2010		**$**		**2010**		**$**
17 Mar	Sales	6,450		16 Apr	Bank	6,450

TABLE 3: MANFREDI'S ACCOUNT IN THE RECEIVABLES LEDGER (PROMPT PAYMENT)

Manfredi					
2010		**$**	**2010**		**$**
17 Mar	Sales	6,450	30 Mar	Bank	6,321
			30 Mar	Discounts allowed	129
		6,450			6,450

TABLE 4: MANFREDI'S ACCOUNT IN THE RECEIVABLES LEDGER (IRRECOVERABLE DEBT)

Manfredi					
2010		**$**	**2010**		**$**
17 Mar	Sales	6,450	28 Dec	Irrecoverable debts	6,450
		6,450			6,450

Here, the discount is 2% of $6,450 which equals $129. The receipt of $6,321 will be recorded on the debit side of Ingrid's Cash Book and the discount allowed to Manfredi on the debit of discounts allowed account (in the General Ledger). Both amounts will be credited to the trade receivables account in the General Ledger, as follows:

	$	$
Dr Cash/Bank	6,321	
Dr Discounts allowed	129	
Cr Trade Receivables		6,450

Allowing discount for prompt payment of invoices is not as common as it once was, and certainly not as common as it is in exams. One reason is that the deal here is quite an expensive one for Ingrid. She has reduced the bill by $129 to get payment 15 days earlier.

If Ingrid earns 5% per annum interest on her bank balance she will recover only about $13 of this (5% of $6,321 x 15/365).

CUSTOMER FAILS TO PAY

It may be that Manfredi does not pay by the due date. At this point Ingrid should implement her procedures to monitor and collect overdue accounts. These should be efficient, fair and legal. Ingrid may ultimately have to employ the services of a debt collector and/or resort to legal proceedings against Manfredi. These procedures are beyond the scope of this article, although some of the basics of good credit control will be covered later.

However, there may come a time when Ingrid has to accept that the amount due from Manfredi will not be collectible. This might be because, for example, Manfredi has been declared bankrupt or has disappeared and cannot be traced.

At this point, Ingrid is going to have to face the fact that her trade receivable of $6,450 is no longer the asset she thought it was because it is now no longer probable that the economic benefits associated with the transaction will flow to her (IAS 18, paragrpah 14 (d) – see above). Suppose that on 28 December 2010 Ingrid decides to write the amount off as an irrecoverable debt. This will be recorded in Manfredi's account in the Receivables Ledger as shown in **Table 4** (left).

The original entry for the write off will be in the Journal:

	$	$
Dr Irrecoverable debts	6,450	
Cr Receivables control		6,450

Invoice due from customer Manfredi written off as irrecoverable

The amounts will then be posted to the double entry system by debiting irrecoverable debts and crediting trade receivables – both accounts will be in the General Ledger.

The trade receivable now ceases to be an asset and becomes an expense. The adverse effect on profit can be significant. If Ingrid sells her goods at a uniform gross margin of 30%, the effect of the non-collection of the amount due can be summarised as shown in **Table 5** at the top of page 4.

TABLE 5: INGRID SELLS HER GOODS AT A UNIFORM GROSS MARGIN OF 30%

	$	
Sales	6,450	70% of 6,450
Cost of sales	(4,515)	
Gross profit	1,935	30% of 6,450
Irrecoverable debts	(6,450)	
Profit/(loss)	(4,515)	

Ingrid will have to make additional sales of $15,050 just to break even (30% of $15,050 = $4,515).

MAKING AN ALLOWANCE FOR RECEIVABLES

Let us now assume that the financial year end for Ingrid is 31 December 2010. The irrecoverable debt arising from the sale to Manfredi has been recognised in the same year in which the sale was made. Ingrid may feel that it would be prudent to make an additional charge for irrecoverable debts based on the total of trade receivables as at the end of the year.

Past experience may suggest that a fairly fixed percentage of trade receivables proves to be uncollectible each year.

Suppose that Ingrid's experience is that on average 3% of trade receivables proves to be uncollectible. This means that if Ingrid's trade receivables as at 31 December 2010 totalled $541,800 then she can expect to write off about $16,254 of this in 2011. It would be appropriate to charge this amount as an expense in the year in which the related sales took place (the matching principle) even though Ingrid will not find out which specific receivables are uncollectible until 2011.

Suppose now that the total trade receivables written off as irrecoverable during 2010 was $196,201 (this will include Manfredi's debt). The total amount charged in the income statement for 2010 will now be:

	$
Irrecoverable debts	196,201
Add end of year allowance for receivables	16,254
Receivables expense for 2010	212,455

And the amount included in current assets in the statement of financial position as at the end of 2010 will be:

	$
Trade receivables	541,800
Less Allowance for receivables	16,254
	525,546

This will all be recorded in the ledger accounts as shown in **Table 6** on **page 5**.

OUT WITH THE OLD AND IN WITH THE NEW

We're not quite finished yet. If 2010 was not Ingrid's first year of operation she would have made an allowance for trade receivables at the end of 2009. So, if Ingrid's trade receivables totalled $400,932 as at 31 December 2009, she would have made an allowance for receivables of $12,028 (3% of $400,932). It is important that this allowance is reversed for 2010 so that the irrecoverable debts of $12,028 anticipated and charged in 2009 are not charged again in the income statement for 2010.

A CREDIT SALE IS ESSENTIALLY A FREE GIFT TO THE CUSTOMER UNTIL THE INVOICE IS PAID.

TABLE 6: INGRID'S LEDGER ACCOUNT

Irrecoverable debts

2010		$	2010		$
Trade receivables		196,201	31 Dec	Income statement	212,455
31 Dec	Allowance for receivables	16,254			
		212,455			212,455

Allowance for receivables

2010		$	2010		$
			31 Dec	Irrecoverable debts	16,254

TABLE 7

Irrecoverable debts

2010		$	2010		$
Trade receivables		196,201	31 Dec	Allowance for receivables (old)	12,028
31 Dec	Allowance for receivables (new)	16,254	31 Dec	Income statement	200,427
		212,455			212,455

Allowance for receivables

2010		$	2010		$
31 Dec	Irrecoverable debts (old)	12,028	01 Jan	Balance b/f	12,028
31 Dec	Balance c/d	16,254	31 Dec	Irrecoverable debts (new)	16,254
		28,282			28,282
			2011		
			01 Jan	Balance b/d	16,254

The total amount charged in the income statement for 2010 will now be:

	$
Irrecoverable debts written off	196,201
Deduct start of year allowance for receivables	(12,028)
Add end of year allowance for receivables	16,254
Receivables expense for 2010	200,427

And the amount included in current assets in the statement of financial position as at the end of 2010 will be unchanged:

	$
Trade receivables	541,800
less Allowance for receivables	16,254
	525,546

This will be recorded in the ledger accounts as shown in **Table 7** (left).

You will note that the allowance for the receivables account has just two entries for the year. At the end of each accounting period the old allowance is taken out and the new allowance is put in. In each case, the other entry is made in the irrecoverable debts account. This is an expense account which is closed off to the income statement each year.

The above method is relatively easy to understand if you are new to this, and it can always be relied on to get the correct figures. The charge in the income statement will always be: receivables written off – last year's allowance for receivables + this year's allowance for receivables.

The figure in the statement of financial position will always be: trade receivables – this year's allowance for receivables.

THE INCREMENTAL APPROACH

This is an alternative way of updating the allowance for trade receivables at the end of each accounting period. It reduces the number of entries in the ledger accounts, but is a bit more difficult to master. Using this method, the start of year allowance for receivables is just changed to give the end of year allowance. The problem is that the change in the allowance may result in an increase or a decrease.

Using the same data as before, the receivables expense charged in the income statement for 2010 will be:

	$
Irrecoverable debts written off	196,201
Increase in allowance for receivables	4,226
Receivables expense	200,427

The amount included in current assets in the statement of financial position as at the end of 2010 will be as before:

	$
Trade receivables	541,800
Less Allowance for receivables	16,254
	525,546

The entries in the ledger accounts will be as shown in **Table 8**.

If the allowance for receivables had been decreased, the allowance for receivables would have been debited with the decrease and the irrecoverable debts account would have been credited. Here's an illustration. Suppose that in 2011 receivables written off as irrecoverable totalled $166,400, and that the allowance for receivables is to be reduced to $15,000. The ledger accounts for 2011 would be as shown in **Table 9**.

TABLE 8

Irrecoverable debts

2010		**$**	**2010**		**$**
Trade receivables		196,201	31 Dec	Income statement	200,427
31 Dec	Allowance for receivables (increase)	4,226			
		200,427			200,427

Allowance for receivables

2010		**$**	**2010**		**$**
31 Dec	Balance c/d	16,254	01 Jan	Balance b/f	12,028
			31 Dec	Irrecoverable debts (increase)	4,226
		16,254			16,254
			2011		
			01 Jan	Balance b/d	16,254

TABLE 9

Irrecoverable debts

2011		**$**	**2011**		**$**
Trade receivables		166,400	31 Dec	Allowance for receivables (decrease)	1,254
			31 Dec	Income statement	165,146
		166,400			166,400

Allowance for receivables

2011		**$**	**2011**		**$**
31 Dec	Irrecoverable debts (decrease)	1,254	01 Jan	Balance b/f	16,254
31 Dec	Balance b/d	15,000			
		16,254			16,254
			2012		
			01 Jan	Balance b/d	15,000

CREDIT CONTROL

Earlier we saw that irrecoverable debts can severely decrease profit (and cash flow). It is therefore important that a business does all it can to reduce the incidence of irrecoverable debts. Some think that good credit control is all about chasing up overdue accounts effectively. In fact, good credit control should start much earlier. The following considerations are the foundations of good credit control:

- Who gets credit?
  The initial screening of potential credit customers is important. A credit sale is essentially a free gift to the customer until the invoice is paid. It is no use making a credit sale to a questionable customer just to achieve the sale. The profit is more than wiped out if the customer defaults. On the other hand, over enthusiastic vetting at this stage could result in lost sales to potentially good customers.
- Terms of credit
  These should be set up and agreed in advance. They will include the credit limit (the maximum amount the customer can owe at any point in time), the credit period, whether discount can be claimed for quick payment, if interest is chargeable if the payment terms are not met, and so on. The terms of credit need not be the same for each customer.
- Administration of billing and collection
  Efficiency here will be important. Invoices should be issued quickly and should be accurate. Customers generally will not pay unless, and until, they receive the invoice, so delays in invoicing will result in delays in payment. Errors in invoices also hold things up. The payment patterns of customers should be known, if possible, and invoices issued to take advantage of these. Businesses should also review their procedures for issuing statements and reminders.

Collection of overdue accounts

As mentioned earlier, procedures here need to be systematic, fair, reasonable and within the law. Avoiding the issue of non-payment, or just hopefully sending out computer generated reminders every few months, are unlikely to be effective.

On the other hand, threatening a customer might be effective but will most likely land the business in court.

FINALLY, SOME GOOD NEWS!

Having written off Manfredi's debt in 2010, Ingrid is surprised to receive a payment of $6,450 from Manfredi in 2011 along with a letter apologising for the delay. There are two ways to record this.

Method A

	$
Dr Bank	6,450
Cr Irrecoverable debts	6,450

Method B

	$
Dr Bank	6,450
Cr Trade receivables (and Manfredi's personal account)	6,450

And

Dr Trade receivables (and Manfredi's personal account)	6,450
Cr Irrecoverable debts	6,450

The difference between the two methods is that Method B reverses the irrecoverable debt write off.

Method A might be appropriate where a full or part payment is received at the end of bankruptcy proceedings or from a debt collection agency.

Method B might be more suitable when full payment is unexpectedly received from the customer. In this situation, the business should question whether it was a bit too hasty in writing the receivable off in the first place, and review its procedures generally.

Donald Halliday is assessor for ACCA's financial reporting papers

IT IS IMPORTANT THAT A BUSINESS DOES ALL IT CAN TO REDUCE THE INCIDENCE OF IRRECOVERABLE DEBTS. SOME THINK THAT GOOD CREDIT CONTROL IS ALL ABOUT CHASING UP OVERDUE ACCOUNTS EFFECTIVELY. IN FACT, GOOD CREDIT CONTROL SHOULD START MUCH EARLIER.