Collection Process

THE COLLECTION PROCESS is the method a company uses to convert accounts receivable into cash. In business-to-business transactions, it is common for a business to accept payment for its sales later, after the purchaser has had a chance to inspect the quality of the goods. What is the risk of allowing a customer to pay later? The customer may not pay at all. How do accountants collect their invoice statements? How do they handle uncollectible accounts?



Objective:

Collect payments and receivables, and estimate uncollectible accounts.

Key Terms:

accounting estimation
accounts receivable
collection agency
collection process
contra-account
control account
credit
income statement approach
invoice
net realizable value
on account
payment
receivable
schedule of accounts receivable
subsidiary account
transaction
uncollectible account

Understanding the Payment Collection Process

Payment is typically a transfer of currency via cash, check, electronic transfer (of funds), or assets to satisfy a promise to pay (compensate). The **collection process** is the methods a company uses to convert accounts receivable into cash. In other words, collection is the way a customer or supplier is prompted to pay the invoice sent by the accounting office. An **invoice** (or vendor invoice) is a bill sent by the seller to a buyer (customer or supplier) who has

Copyright © by CAERT, Inc. — Reproduction by subscription only.

received goods and/or services on credit; it records a sale on account. An invoice contains the payee's name/company, the product or service name, quantity of the good or service, the agreed upon price, and a date on which the invoice is due.

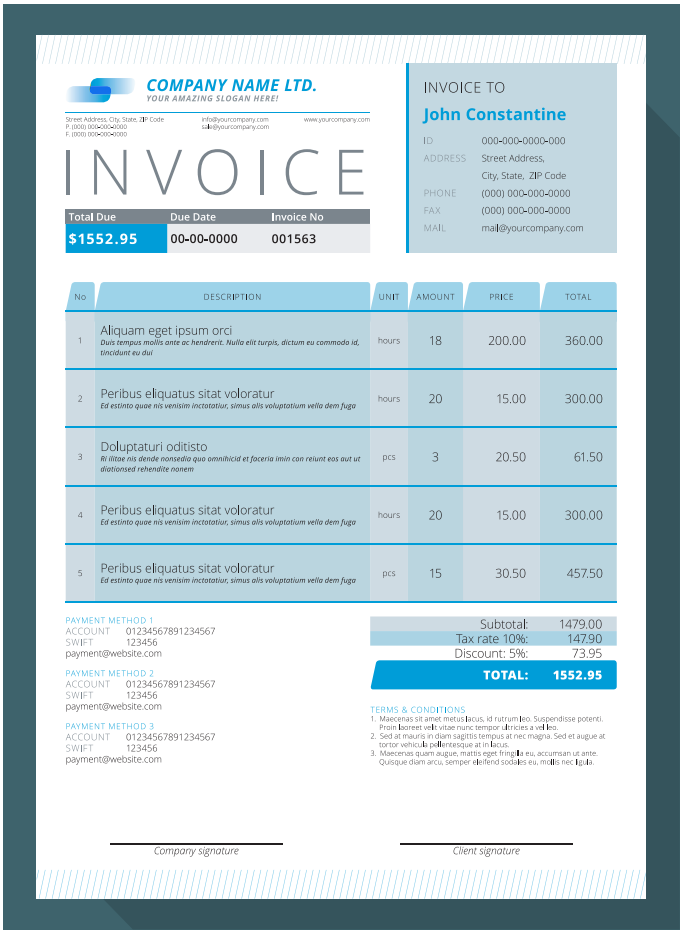


FIGURE 1. An invoice is a bill sent by the seller to a buyer that has received goods and/or services on credit; it records a sale on account. An invoice contains the product or service name, quantity of the good or service, the agreed upon price, and a date the invoice is due.

ONSET OF ACCOUNTS RECEIVABLE

A **receivable** is the amount due from a customer, supplier, or any other party and is considered a company asset (valuable possession). The term applies to all unsettled (unpaid) transactions or other types of monetary indebtedness (an amount owed to a company by its debtors or customers). Receivables are categorized as accounts receivable, notes receivable, etc.

Credit is the borrowing capacity of a company. A transaction in which payment will be accepted later is **on account** (e.g., "A customer purchased an item *on account*…"). Credits are recorded on the right side of a T-account. Customers must meet various requirements for a company to extend them business credit.

Sales Transaction Accounts

A **transaction** is a business event that changes asset, liability, or net worth accounts. Transactions are recorded in the appropriate accounting records. The accounts used in a sales transaction are Sales and Cash or Accounts Receivable accounts. A sales transaction affects a revenue account and an asset account.

Accounts receivable is a current asset account that reflects the balance of amounts owed the company by customers—an account for charge customers. Current assets result from selling goods and services on credit.

- Accounts receivable is a **control account**, which is an account that stores the final balance of lower level balances (e.g., customer accounts). The lower level balances that roll up to a control account are considered a **subsidiary account**.

Copyright © by CAERT, Inc. — Reproduction by subscription only.

- The journal entry for sales transactions paid with cash is a debit to the Cash account and a credit to the Sales account.
- The journal entry for a sales transaction on account is a debit to the Accounts Receivable account and a credit to the Sales account.

When payment is received from a customer *on account*, the entry is a debit to the Cash account and a credit to the Accounts Receivable account. (NOTE: The last entry eliminates the balance in the Accounts Receivable account, and the remainder is a debit in the Cash account and a credit in the Sales account.)



FIGURE 2. Accounts Receivable—the control account—is the total of all customer accounts. The subsidiary accounts are the detailed accounts that roll up to Accounts Receivable.

Accounts Receivable Schedule

A **schedule of accounts receivable** is a report or a listing (generated by the Accounts Receivable system) that records each customer and how much each owes. The total of all accounts on the schedule must total the balance in the control account—accounts receivable.

The schedule can be modified (queried) to search for large amounts owed or for specific customers. This process is useful for generating notices regarding past due balances and for reviewing outstanding balances at various intervals (e.g., 30 days, 60 days, and > 120 days).



ON THE JOB...

CAREER CONNECTION: Jobs in Accounts Receivable

In large companies, entire Accounts Receivable departments exist. The department's accountants and support staff maintain the entire process of granting credit to customers, monitoring discounts, recording payments, analyzing past due balances, writing off accounts, and working with collection agencies. Some of the accounts receivable job titles are Accounts Receivable Manager, Revenue Accountant, Accounts Receivable Clerk, and Billing Specialist. While the supporting roles earn hourly rates between $14 and $21 an hour, specialized management positions may earn an average salary of $52,000 annually.

Copyright © by CAERT, Inc. — Reproduction by subscription only.

Unpaid Accounts

Accounts that remain unpaid for an excessive period of time may be "written off" (removed from the books) or may be sold to a collection agency. A **collection agency** is a business that purchases another company's receivables and assumes the process of acquiring payment.



FIGURE 3. Each business has its own set of policies regarding when to "write off" an account and when to sell the account to a collection agency.

ESTIMATE UNCOLLECTIBLE ACCOUNTS

An **accounting estimation** is a type of cost control measure in which an approximate amount is calculated to be debited or credited for goods/services that have no precise way to be measured. Estimates are based on the accountant's judgment and specialized knowledge from past experience. Bad debt estimates usually mean the accountant must estimate the number of customers who will default on their accounts and the dollar value associated with those accounts. Accounting estimates rely on:

- Historical information (numbers that rarely change)
- Documentation (using the vendor contract to estimate numbers)
- Personal calculations (notes from prior financial statements for use as a future reference)

An **uncollectible account** is an account receivable thought to have no chance of being paid. It is expected that a certain number of the customers granted credit will not pay their bills. Since this expectation is a normal occurrence of doing business, an entry must be recorded to estimate uncollectible accounts.

The entry is a debit to the Bad Debts Expense account and a credit to the Allowance for Uncollectible Accounts account. The Allowance for Uncollectible Accounts is a contra-account. A **contra-account** is an account that has a balance opposite of the normal balance; it reduces a related account on a financial statement.

Income Statement Approach

The **income statement approach** (for estimating bad debts) is a method of approximating uncollectible accounts by calculating a percentage of credit sales. In this method, the percentage is determined by analyzing past trends in unpaid credit sales. For example:

Copyright © by CAERT, Inc. — Reproduction by subscription only.

If a company determines 3 percent of credit sales are not collectible, the entry on credit sales of $100,000.00 would be a $3,000.00 debit to the Bad Debts Expense account and a $3,000.00 credit to the Allowance for Uncollectible Accounts account.

The asset account balance Accounts Receivable less the contra-account balance of Allowance for Uncollectible Accounts account is the net realizable value of Accounts Receivable. Therefore, **net realizable value** is the amount expected to be collected.

Aging of Accounts Receivable Approach

The Aging of Accounts Receivable account is another method of estimating the amount of bad debt. This account analyzes past due balances. An example of using this estimation method process is:

A company trends (a tendency to) the payment history of accounts between 30 and 60 days past due, 60 to 90 days past due, and so on. The percentage of accounts that go unpaid is applied to each time interval of past due accounts to arrive at the total of estimated uncollectible accounts.

The amount determined to be uncollectible is the *balance* of the Allowance for Uncollectible Accounts account. Should there be a balance in the account from a previous period, the entry is for the amount that brings the balance of the allowance account to the estimated amount.

Summary:



A percentage of customers will not pay their invoices. As a normal risk of business, an estimate and an entry must be made to anticipate and more correctly state the expected amount of Accounts Receivable that will be collected. A company estimates uncollectible accounts by analyzing the value of the Sales account or the trends associated with historical past due accounts in Accounts Receivable.

Checking Your Knowledge:



1. Explain the term “on account.”
2. How is an account labeled as an “uncollectible account?”
3. Which accounts are used to record the estimate of uncollectible accounts?
4. What is a contra-account?
5. Describe two methods for estimating uncollectible accounts.

Expanding Your Knowledge:



Choose a publicly held company to review. Look up the company’s financial statements and annual report. Research which method of estimating uncollectible

Copyright © by CAERT, Inc. — Reproduction by subscription only.

accounts is used by the company and what data they choose to share. Record this information for discussion.

Web Links:



Collection Procedure

http://www.accountingtools.com/procedure-collections

Direct Write-Off and Allowance Methods for Dealing with Bad Debt

http://accountinginfocus.com/financial-accounting/accounts-receivable/direct-write-off-and-allowance-methods-for-dealing-with-bad-debt/

Writing Off an Account

http://www.accountingcoach.com/accounts-receivable-and-bad-debts-expense/explanation/4

Copyright © by CAERT, Inc. — Reproduction by subscription only.