

# **Accounting 101**

## **Chapter 7 – Accounts and Notes Receivable**

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#### **Receivables – Why they are important**

At this point, we begin to study financial accounting topics not covered in Accounting 100. This chapter will be challenging because all material is new. Therefore, make certain to devote the proper amount of time to the course material.

A receivable is an amount due from another party. Receivables are usually one of the largest current assets on a company's books. The control and analysis of this asset is very important, because receivables are usually the biggest source of a company's cash flow. What happens when your cash flow at home is reduced? You have trouble paying your bills, leading to financial hardship. Companies face this same issue. The proper control over accounts receivables is very important.

#### **Common types of receivables**

**Accounts Receivable.** Accounts Receivable are the most common kind of receivable. Accounts Receivable are amounts due from customers from the sale of services or merchandise on credit. They are usually due in 30 – 60 days. They are classified on the Balance Sheet as current assets.

**Notes Receivable.** Notes Receivable can arise when the seller asks for a promissory note to replace an Accounts Receivable when the customer requests additional time to pay a past-due account. A promissory note is a written promise to pay a specific amount of money, usually including interest, at a future date. If the note is due within a year it is classified as a current asset. If the note is due after one year, it is classified as a long-term asset.

**Other Receivables.** Examples of other receivables are income tax refunds, interest receivable, or receivables from employees. These are not covered in this chapter.

#### **Uncollectible Accounts Receivable**

In order to help minimize credit losses, a company needs to be very careful and prudent in extending credit. References and credit scores should be checked and credit worthiness needs to be established before credit is granted.

Once a receivable becomes past due, companies need to put forth great efforts to collect it. The older a receivable gets, the less likely the chance of collection.

A business will usually have some customers that will not pay their debts. GAAP requires that a company estimate the amount of uncollectable receivables at the end of the accounting period and record that amount as Bad Debt Expense. The Bad Debt Expense is recorded in the same year as the sale, complying with the matching principle.

## The Allowance Method

As previously mentioned, there will always be customers that don't pay. This could be due to a dispute over the amount owed, or due to cash flow problems experienced by the customer. The amount estimated as uncollectible will be debited to a new operating expense called Bad Debts Expense. The Bad Debts Expense will be recorded in an adjusting entry that debits Bad Debts Expense and credits Allowance for Doubtful Accounts. The Allowance for Doubtful Accounts is a contra asset account with a normal credit balance. It will offset the Accounts Receivable balance. The presentation of Accounts Receivable and the Allowance for Doubtful Accounts on the balance sheet is often reported as follows.

Accounts Receivable	100,000	
Allowance for Doubtful Accounts	<u>(1,000)</u>	99,000

The \$99,000 shown above is called the "realizable value" and estimates what the company can realistically expect to collect from their account receivables.

GAAP mandates that we use the Allowance Method of estimating uncollectible accounts receivable. (The Direct Write Off method is used by some smaller companies, because it is needed for tax purposes; it is not acceptable under GAAP.) Most companies estimate their uncollectible accounts receivable using one of three approaches:

1. The percent of sales method
2. The percent of receivables method
3. The aging of receivables method

The method chosen will determine the calculation. We will practice these methods of determining the adjustment for bad debts expense extensively in class. These methods are summarized below.

- 1. The percent of sales method.** Under this method, the amount of the adjustment is calculated by multiplying a historical percent of bad debts by the current year's net credit sales. Although acceptable, this method is not as accurate as either the percentage of receivables method or the aging of receivables method.

**Example:** A company had net sales of \$1,000,000. It is estimated that one percent of net sales are uncollectible. The amount of the adjusting entry is \$10,000 ( $1\% * \$1,000,000$ ). The adjusting entry recorded at the end of the accounting period is

Bad Debts Expense	10,000	
Allowance for Doubtful Accounts		10,000

- 2. The percent of receivables method.** The percent of receivables method assumes a given percent of a company's receivables is uncollectible. The desired amount of the Allowance for Doubtful Accounts is calculated by multiplying Accounts Receivable by this percent. The Allowance for Doubtful Accounts is then adjusted so that it equals this desired amount.

**Example:** The balance of Accounts Receivable is \$100,000, and it is estimated that 5% of accounts are uncollectible. The balance of the Allowance for Doubtful Accounts, before adjustment, is \$2,000 (credit). The desired balance of the Allowance for Doubtful Accounts would be \$5,000 ( $\$100,000 * 5\%$ ). Since the balance of the Allowance for Doubtful Accounts is now only \$2,000, a \$3,000 adjustment is required, as follows.

Bad Debts Expense	3,000	
Allowance for Doubtful Accounts		3,000

- 3. The aging of receivables method.** Most companies have an aging of customers' accounts receivable. In this aging report, each customer balance is classified by how long it is past due. Based on this aging, experience is used to estimate the percent of each aging total. Older past due receivables will be more likely uncollectible. Once the total uncollectible amount is estimated, an adjusting entry is made to increase the Allowance for Doubtful Accounts so that its balance equals the uncollectible estimate calculated by using the aging report.

**Example:** Based on its aging report, a company estimates its uncollectible accounts receivable to be \$6,000. The current balance in the Allowance for Doubtful Accounts is \$1,000 (credit). An adjusting entry of \$5,000 ( $\$6,000$  desired less  $\$1,000$  balance before adjustment) would be recorded as follows.

Bad Debts Expense	5,000	
Allowance for Doubtful Accounts		5,000

## Writing off a Bad Debt

Strict internal control procedures should be used when writing off an account that is no longer deemed collectible. We will discuss these in class. For example, the entry to write off the \$500 balance owed by Mahoney Company is

Allowance for Doubtful Accounts	500	
Accounts Receivable-Mahoney Company		500

Note that Bad Debts Expense is not used to record the write off. This is because Bad Debts Expense was debited in the adjusting entry to estimate bad debts. If Bad Debts Expense was debited in the entry to write off a bad debt, Bad Debts Expense would be counted twice.

## Collection of a bad debt previously written off

If a company collects an accounts receivable balance previously written off, two entries are required. The first entry reverses the write off. The second entry records the cash receipt on account. For example, assume Lee Company pays its \$350 account previously written off, the following entries would be recorded.

Accounts Receivable-Lee Company	350	
Allowance for Doubtful Accounts		350
Cash	350	
Accounts Receivable-Lee Company		350

## Notes Receivable

Notes Receivable can arise when the seller asks for a promissory note to replace an Accounts Receivable when the customer requests additional time to pay a past-due account. A promissory note is a written promise to pay a specific amount of money, usually including interest, at a future date. The journal entries required are:

- Converting an accounts receivable to a note receivable
- Recording an adjusting entry for interest receivable at the end of the accounting period
- Recording receipt of note payment and interest when due
- Recording a dishonored note

## Computing Maturity Date and Interest

The maturity date is the date repayment of the note is due. The interest charged to the issuer of the note is a cost of borrowing money for the borrower. We should learn to calculate both.

For example, assume a \$1,000, 6%, 90-day note was issued on July 15. The maturity date would be October 13, as follows:

July (31 days in July minus 15, the date of the note)	16
August	31
September	30
October	<u>13</u>
Period of the note, in days	<u>90</u>

To compute interest, multiply the principal of the note by its interest rate and the time factor.

For example, the interest due on the note receivable above is \$15, calculated as follows:

$$\$1,000 * 6\% * 90/360 = \$15$$

## Recognizing Notes Receivable and Settling Notes Receivable

A seller can accept a note from a customer to grant a time extension on a past-due receivable. As an example, assume GlobalCom accepted \$100 in cash along with a \$900, 30-day, 12% note from Chef Enterprises on July 5 to settle their \$1,000 past-due account. GlobalCom would make the following entry.

July 5	Cash	100	
	Notes Receivable	900	
	Accounts Receivable-Chef Enterprises		1,000

Assume Chef Enterprises paid the amount due with interest on the due date. GlobalCom would record the payment as

Aug. 4	Cash	909	
	Notes Receivable		900
	Interest Revenue (\$900 * 12% * 30/360)		9

If Chef Enterprises did not pay the amount due on August 4, the note would become *dishonored*. In that case, GlobalCom would have made the following entry:

Aug. 4	Accounts Receivable-Chef Enterprises	909	
	Notes Receivable		900
	Interest Revenue		9

### The Adjusting Entry for Interest Receivable

When a note receivable is outstanding at the end of an accounting period, any interest due but not yet received must be recorded. For example, assume a \$2,000, 30-day, 6% note receivable was issued on December 19, 2010. The adjusting entry at December 31 is

2010

Dec. 31	Interest Receivable	4	
	Interest Revenue ( $\$2,000 * 6\% * 12/360$ )		4

The payment of the note and interest on January 18, 2011 is recorded as follows.

2011

Jan. 18	Cash	2,010	
	Notes Receivable		2,000
	Interest Receivable		4
	Interest Revenue ( $\$2,000 * 6\% * 18/360$ )		6

### Disposing of Receivables

Companies sometimes convert receivables to cash before they are due to raise needed cash. This can be accomplished in two ways.

- (1) **Selling (Factoring) Receivables.** A company can sell its accounts receivables to a finance company. The finance company will charge the seller a factoring fee and take ownership of the receivables. In this case, the finance company assumes the risk of bad debts.
- (2) **Pledging Receivables.** A company can also borrow money from a finance company or bank and pledge its receivables as security for the loan. Unlike factoring, this does not transfer risk of bad debts. If the loan is not paid back the lender can take title to the receivables pledged. Any pledged receivables must be disclosed in the notes to the financial statements.