John Petroff, Nancy Paz, Tibebe Mengistu, and KAREN DE AVILA (2011)

Chapter 9
Receivables

INTRODUCTION TO RECEIVABLES

Receivables are any monetary claims against debtors. Credit can be granted in two forms: open account or evidenced by a formal instrument. When a formal instrument of credit, that is a promissory note, the creditor has a stronger legal claim and can endorse it to a third party. The party that promises payment is known as the maker, and the party entitled to receive the payment is the payee. Notes receivable can be interest or non-interest bearing. The amount due at maturity, known as maturity value, is equal to the face value plus any accrued interest. Receivables not expected to be collected within the current year, should be listed as investments on the balance sheet.

RECEIVABLE CONTROLS

Receivables require the same internal controls as other assets of a business. Employees responsible for collecting and approving receivables should not be involved with accounting aspect related to them. All accounting functions should be designed so that the work of one employee can be used as verification of another employee's work. A business that has a substantial amount of notes may find the use of a notes receivable register very helpful. It provides detailed information on each note, and assists in the timely collection of notes. Proper controls of receivables also includes obtaining approval for credit sales, sales returns and allowances, and sales discounts.

CALCULATING INTEREST

Interest rates are usually stated on an annual basis. The interest is computed by multiplying principal by rate and then by time (principal x rate x time). The maturity value is determined by calculating interest and adding it to the face value of the note. When interest is computed for periods of less than a year, time is expressed as a fraction. The numerator of the fraction is the length of the note and the denominator is the number of days in a year. Government agencies use 365 days in the denominator, while the private sector uses 360 days.

Attributed to: John Petroff, Nancy Paz, Tibebe Mengistu, and Karen De Avila
BY-NC-SA

ACCOUNTING FOR NOTES RECEIVABLE

When a note is received from the debtor (i.e. open account customer), a journal entry should be made debiting Notes Receivable and crediting Accounts Receivable account. Notes receivable that do not mature by the end of a fiscal period, require both adjusting and reversing entries for the accrued interest. This is done so that interest income is allocated to the proper financial periods. When a note matures and is paid, the Cash account is debited and the Notes Receivable and Interest Income accounts is credited.

DISCOUNTING A NOTE RECEIVABLE

In the event a business is in need of cash, it has the option to transfer its notes receivable to a bank, which is known as discounting. The interest a bank charges on the period it holds a note is known as discount. Depending upon the arrangement with the bank, the company may still be liable in the event a debtor defaults on the payment. It is necessary to disclose these contingent obligations on a firm's Balance Sheet in a foot note. When proceeds are received for the discounted notes, the Cash account is debited, and the Notes Receivable account credited. If the proceeds exceed the face value of the note, the Interest Income account is credited. If the proceeds are less than the face value of the note, Interest Expense is debited.

DISHONORED NOTES RECEIVABLE

When the maker of a note fails to pay on the due date, the note receivable is considered to be dishonored. A dishonored note is no longer negotiable. In the books of creditors, the following entry is made :

Debit Accounts Receivable
Credit Notes Receivable
Credit Interest Income or Interest Receivable

When a note previously discounted with a bank is dishonored, the holder of the note (the bank) notifies the endorser (i.e the company) of non-payment. Protest fees are charged to the endorser for legal fees.

> Accounts receivable are sales on credit made to customers that have not yet been collected in cash. Accounts receivable are discounted based on:
>
> a. Trade discount – discount based on sales volume
>
> *Example:*
> Price per unit will be $8.50 for sales of more than 200 units.
> The volume discount is $1.50.

Attributed to: John Petroff, Nancy Paz, Tibebe Mengistu, and Karen De Avila
BY-NC-SA

b. Terms of payment

Example:
This means that a 2% discount will be given to a customer for the amount paid within 15 days while the unpaid amount should be settled in 30 days.

c. Cash discount – discount is given if full amount is paid within a normal credit period.

Example 1:
Customers will be given 2% discount if they pay in cash at the time of sale.

Example 2: $25 is the selling price per unit.
Customers will be given 1% discount if they fully pay within 5 days.

RECEIVABLES WHICH BECOME UNCOLLECTIBLE

No matter what kind of credit policy or collection procedures a business establishes, a certain percentage of receivables will usually turn out to be uncollectible. When a receivable is determined to be uncollectible, it is written-off as an operating expense. Strong indications that a receivable may be uncollectible are the declaration of bankruptcy by the debtor, repeated failures to collect, disappearance of the debtor, and debts that are beyond the statute of limitations. Two methods exist to write-off receivables. The direct write-off method records the expense when the receivable is uncollectible, while the allowance method makes a provision for a portion of the current year sales to become uncollectible throughout the entire year.

THE ALLOWANCE METHOD

The allowance method of accounting for uncollectibles estimates the percentage of accounts that will be uncollectible. Once the amount is determined, an adjusting entry is made that debits the Uncollectible Accounts Expense and credits the Allowance for Doubtful Accounts (also known as Allowance for Bad Debt). When a specific account is determined to be uncollectible, the Allowance for Doubtful Accounts is debited and the Accounts Receivable account is credited. The advantage of using the allowance method is it provides a reduction of the value of receivables and recognition of expense in the period the corresponding sales have taken place.

BY-NC-SA

Example:

1. December 31, 2010

Company Y believed that it has $25,000 unsettled accounts receivable for the year and an allowance should be recorded in the books.

Journal entry to establish allowance

	Debit	Credit
Bad debts expense	$25,000	
Allowance for bad debts		$25,000

2. January 25, 2011

Company Y's customer, Company X, filed for bankruptcy. Company X had to pay Company Y$5,000.

Journal entry to write off accounts receivable from Company X

	Debit	Credit
Allowance for bad debts	$5,000	
Accounts receivable		$5,000

METHODS USED TO ESTIMATE UNCOLLECTIBLES

There are several methods of estimating uncollectibles. The most commonly used methods base their estimates on sales data or the age of the receivables. Estimates based on sales figures can be determined by taking a percentage of either total sales or credit sales. An estimate of uncollectibles based on an analysis of receivables, classifies accounts into outstanding age groups. The longer a receivable is past due, the higher the probability of nonpayment. If the estimate is larger than the balance of the Allowance for Doubtful Accounts, the excess should be debited to the Uncollectible Accounts Expense and credited to the Allowance for Doubtful Accounts.

BY-NC-SA

a. Percentage of sales method

Example:
Company EP assumes that 5% of total sales will not be collected. Sales for the year was $500,000.

Journal entry

	Debit	Credit
Bad debts expense	$25,000	
Allowance for bad debts		$25,000

b. Aging schedule method

Aging schedule of accounts receivable determines the likelihood of the receivables' collection or the probability of the customers' default of payments based on the company's credit policy.

Example:
Company A evaluates the percentage of bad debts based on the age of accounts receivable balances. This is done to record the approximate value of the allowance for doubtful accounts.

Age of Balance	**Balance**	**% of Doubtful Accounts**	**Allowance**
<="" td="">	$95,000	2%	$1,900
31 – 60 days	$50,000	4%	$2,000
61 – 90 days	$18,000	7%	$1,260
Over 90 days	$ 7,000	12%	$ 840
Total	**$170,000**		$6,000

Journal entry to record allowance

	Debit	Credit
Bad debts expense	$6,000	
Allowance for bad debts		$6,000

Source URL: http://www.peoi.org/Courses/Coursesen/ac/fram9.html
Saylor URL: http://www.saylor.org/courses/prdv201/

Attributed to: John Petroff, Nancy Paz, Tibebe Mengistu, and Karen De Avila
BY-NC-SA

THE DIRECT WRITE-OFF METHOD

The direct write-off method only records an uncollectible account expense when an account has been determined to be uncollectible. This method is not recommended the recognition of the expense does always occur in the year the corresponding revenues were recorded. It has, however, the advantage of simplicity since no adjusting entry is necessary at the end of a financial period. The method is best used by businesses that do not have a large number of credit sales. In the event an account needs to be reinstated, the Accounts Receivable account is debited. Uncollectible Accounts Expense should be credited.

Journal entry to write off bad debts

	Debit	Credit
Uncollectible Accounts Expense	XX	
Accounts Receivable		XX

Journal entry to recover receivables

	Debit	Credit
Accounts Receivable	XX	
Uncollectible Accounts Expense		XX

Attributed to: John Petroff, Nancy Paz, Tibebe Mengistu, and Karen De Avila
BY-NC-SA