

Alkan health sciences business and technology

Accounts & Budget Support LEVEL III

Unit of Competence

Administer Subsidiary Accounts and Ledgers

Module Title

Administer Subsidiary Accounts and Ledgers

LG Code: [BUF ACB3 02 0812](#)

TTLM Code: [BUF ACB3M 02 0812](#)

INTRODUCTION

Welcome to the module “**Administer Subsidiary Accounts and Ledgers**”. This learner’s guide was prepared to help you achieve the required competence in “**Accounts and Budget Support Level III**”. This will be the source of information for you to acquire knowledge attitude and skills in this particular occupation with minimum supervision or help from your trainer.

Summary of Learning Outcomes

After completing this learning guide, you should be able to:

Lo1:- Review accounts receivable process

Lo2:- Identify bad and doubtful debts

Lo3:- Review compliance with terms and conditions and plan recovery action

Lo4:- Prepare reports and file documentation

Lo5:- Distribute creditors invoices for authorization

Lo6:- Remit payments to creditors

Lo7:- Prepare accounts paid report and reconcile balances outstanding

How to Use this TTLM

- o Read through the Learning Guide carefully. It is divided into sections that cover all the knowledge, skills and attitude that you need.
- o Read Information Sheets and complete the Self-Check at the end of each section to check your progress

- o Read and make sure to Practice the activities in the Operation Sheets. Ask your trainer to show you the correct way to do things or talk to more experienced person for guidance.
- o When you are ready, ask your trainer for institutional assessment and provide you with feedback from your performance

Lo1:- Review accounts receivable process

Receivables usually composed substantial components of a firms current assets, thus considered as important factor in evaluating the financial position of a firm. In common they are resulted from events such as sale of goods or services, loans made, subscriptions obtained from investors for capital stock or bonds, claims for income tax refunds, claims resulting from litigation, etc. Receivables from customers frequently represent a substantial part of a business enterprise's current assets. Poor screening of applicants for credit or an inefficient collection policy may result in large loses. Consequently, strong accounting controls and effective management of receivables are typical characteristics of most profitable enterprises.

Receivables may be classified in different manner, such as:

Trade Receivables: they are also called receivables from sales of goods and services. They result from ordinary revenue-producing activities and they include accounts receivables, installment receivables, or notes receivables.

Non-Trade Receivables:- These are receivables from miscellaneous sources.

Classification of receivables

These are receivables resulting from services which are non-recurring or unusual transactions.

Examples include:

- ❖ Claims against insurance companies, legal suit for damages.
- ❖ Prospective retuning
- ❖ Deposits to cover damages, as guarantee
- ❖ Receivables from employees or officers
- ❖ Receivables from sale of other assets such as from disposal of plant assets
- ❖ Accrual of interest, dividend, rent, royalties
- ❖ Overpayment of trade accounts payable, etc.

Receivables may also be classified as **open account** (a non-written promise to pay) or a **note** (a written promise to pay). Open accounts are less formal, mostly non-interest bearing and used for a shorter period, involve lesser amount. On the other hand, notes receivables are represented by promissory notes that give them a stronger status than ordinary open accounts

Accounting System and Internal Control

Effective internal control over sale of goods and related cash collections are integral parts of the system for handling trade accounts receivable. For effective handling of receivables the following mechanisms should be applied in a business organization:

Segregation of duties: This means separation of responsibilities in a business firm. An individual who is assigned for recording sales and collection of trade receivables should not be assigned in handling cash receipts or in preparing bank deposit slips.

Cycle billing:- It is a procedure that insures timely collection of receivables and it involves billing customer at different time schedules after getting customers classified on different basis such as geographic location or type of customer.

Accounting Activities for Trade Receivables

In trade receivables the following major activities are treated:

- Recognition of receivables
- Valuation of receivables
- Disposition of receivables

Recognition of receivables: In recording trade accounts receivables the following two questions should be answered.

1. At what point in the earning process should a trade accounts receivable be recorded? And
2. How should the net amount of a trade accounts receivable be measured so that related asset, revenue and expense accounts will be accounted accurately?

The answer for question No. 1 is: Trade accounts receivable is recorded when sales are made and title to the goods is transferred to the buyer, i.e., at the point of sale. It should be noted that when customer order is received, goods

are produced or when goods are shipped on consignment receivables should not be recorded or recognized. However, receivables may be recorded for work completed on construction type contracts. This is congruent with revenue recognition for long-term project under percentage completion method.

In recording/ recognizing receivables the following factors should be taken into consideration.

- ❖ Trade discount
- ❖ Cash/sales discount
- ❖ Estimated collection costs for receivables
- ❖ Sales returns and allowance
- ❖ Allowance for freight-out (Transportation costs)
- ❖ Sales tax
- ❖ Container deposits (Cash Debit and Credit container deposit liabilities)

Valuation of receivables: It involves determining the net realizable value (present value) of claims from customers considering the amount due and the estimate of the probability that the receivable will be collected. This process recognizes doubtful account expense or bad debt expense related to non-collectability of receivable. Receivables that will never be collected have a zero value, and the related revenue will not be realized. Thus, the major objective of estimating this doubtful account is to prevent an overestimate of assets and revenue in the accounting period in which the sales are made.

Two accounting methods may be adopted to account for doubtful accounts.

a. Allowance method or reserve method

b. Direct-write-off method or direct charge of method.

- a. **Allowance method:** Under this method, adjustments are made at the end of each accounting period in order to estimate the amount of receivable that is probable to be unelectable. An account called allowance for doubtful account is used and the adjusting entry at the end of the year for this method is presented as follows:

Doubtful account expense -----	xxx
Allowance for doubtful account -----	xxx

The objective of this adjustment is to prevent overstatement of assets and revenues in the period in which the sales is made.

The net realizable value (carrying amount) of trade accounts receivable which is reported on the balance sheet is calculated as follows:

$$\begin{array}{rclcl} \text{NRV of A/R} & = & \text{Accounts} & - & \text{Balance of valuation} \\ \text{(Carrying amount)} & & \text{receivable (gross)} & & \text{allowance} \\ \text{accounts} & & & & \end{array}$$

(After adjustment)

The doubtful account expense recorded may be reported in the income statement as operating expense (most commonly used practice) or as other non-operating expense or as a deduction from sales.

Illustration: Account balance of accounts receivable for **pear trading** at December 31, year 6 is determined to be a positive balance of \$60,000. On the other hand, allowance for doubtful accounts has a credit balance of \$ 2,000 before adjustment and 5% of accounts receivable is estimated to be uncollectible.

Required:

- ❖ Compute the total amount of the allowance for doubtful account
- ❖ Compute the net realizable value of the receivable
- ❖ Record the adjusting entry

Solution: Current provision for doubtful account = (5%) (60000) = 3000

∴ Adjustment amount bad debt expense is: 3000-2000 = 1000

- The net realizable value of the account receivable at the end of the year (December 31, year 6) is \$60,000 - \$3,000 = \$57,000

- The adjusting entry on December 31, year 6 is:

Doubtful account expense (bad debt expense)	-----	1000
Allowance for doubtful account	-----	1000

Note that when a given customer's receivable is manifested uncollectible due to various reasons the account will be written-off as uncollectible and the entry would be:

Allowance for uncollectible account	-----	xxx
Accounts receivable (specific customer)	-----	xxx

This entry has no effect on the net income of the accounting period, on the receivables account and allowance for uncollectible account.

After accounts receivable is written-off, it is possible for organizations to collect the mount written-off either in full or partially. This is called recovery or reinstatement of accounts receivable written-off and the entry would be:

Accounts receivable	-----	xxx
Allowance for doubtful account	----	xxx

This is to reverse the written of entry

Cash	----	xxx
Accounts receivable	xxx	

This is to record the collection of cash

Illustration: Assume that Pear Trading, in the above illustration, write off a customer's account that is considered to be uncollectible for \$ 670. Assume, further that \$450 cash is collected from the customer whole account had been written of (670)

Required: Record the necessary entries

Solution:

Allowance for doubtful account	----	670
Accounts receivable	----	670

This is to record the written-off accounts receivable

Accounts receivable	-----	450
Allowance for accounts receivable	-----	450

To reinstate the customer's account

Cash	-----	450
A/R	-----	450

To record the collection

- b. **Direct written-off method:** This is another method of recognizing doubtful account expense. Under this method there is no provision or estimation of uncollectible for receivables and does not record doubtful accounts beforehand unless specific accounts are identified to be

uncollectible. This method is sometimes called **specific write-off method**.

It is only upon discovery of specific receivable determined to be uncollectible, specific customer defaulting, a write-off entry performed to record doubtful account expense and cancel the balance from accounts receivable account with the related account in the subsidiary ledger, i.e., the entry to record when a special customer is found defaulted would be:

Doubtful account expense	-----	xxxx
Accounts receivable	-----	xxxx

Under this method, no adjusting entry is required at the end of the period and a valuation allowance account is not maintained for doubtful accounts.

Recover of written-off Accounts Receivable

Under the direct-written-off method, similar to the case in the allowance method, when an amount is, either partially or in full, collected there are two entries recorded.

- i) when the amount is recovered in the same period in which it is written-off; where the doubtful account is not yet closed the entry would be:

Account receivable	-----	xxx
Doubtful account expense	-----	xxx

To record the reversal entry

Cash	-----	xxx
A/R	-----	xxx

To record the collection of cash

- ii) When the amount is recovered in subsequent periods after it is written-off it is common to credit "doubtful account recovered" account for the balance recovered. This account is reported separately in the income statement as other revenue. The journal entry follows are:

Account receivable	-----	xxx
Doubtful account recovered	-----	xxx

This is to record the recovered amount after it was written-off in one period and recovered in another period.

Cash	-----	xxx
------	-------	-----

This is to record the collection.

Even if the direct write-off method appears simple and convenient, it has the following limitations

- ❖ It makes no matching of doubtful account expense with current period revenue.
- ❖ It overstates the carrying amount of receivables.

Disposition of receivables

Disposition of receivables are financing transactions that are commonly used as a source of cash. It shortens the operating cycle and avoids short-run cash flow problems instead of waiting until customers pay their accounts. Conversion of accounts receivables into cash may be facilitated through three means:

- ❖ Selling receivable
- ❖ Pledging receivables as collateral for loans
- ❖ Assigning receivables

Enterprises engaged in the buying of receivables are known as **factors**, and the process of selling receivables is called **factoring**. Factors generally buy receivables outright, that is, without recourse. Alternatively, factors or other lending institutions may buy receivables with recourse, or may lend money to the owner of the receivables under a legal arrangement known as **assignment**. In such cases customers generally are instructed to make payments directly to the factors or other lenders. Factoring is an important source of ready cash in different types of business enterprises.

A pledge of accounts receivable as a collateral for a loan involves no special accounting problems. Accounting for the sale and the assignment of account receivable is described in the following sections.

Sale of Receivables

Factoring of receivables involves selling receivables to a third party. Two parties are involved with the transactions: **Transferor** (one who transfers the receivables) and **Transferee** (the factor or lending institution).

Sale of receivables can happen in two ways:

Without recourse: This involves the shifting of the risk of credit losses, the effort of collection and the waiting period that result from the granting of credit to the purchaser of the receivables. But, sales returns and sales discount, issues are to be considered by the transferor.

With recourse basis: when receivables are sold with recourse, the seller (transferor) in effect guarantees the receivables, and the purchaser (transferee) is reimbursed for failure of debtors to pay the full amount anticipated at the time of sale.

This type of transfer is accounted and reported as sale of accounts receivable only when all of the following three conditions are met:

- ❖ The transferor surrenders control of the future economic benefits of the receivables; i.e., the transferor does not retain the option to purchase the receivable later.
- ❖ The transferor can estimate the collectability of receivables in the future.
- ❖ The transferee cannot require the transferor to purchase the receivables.

If any of the above condition is not met, the transferor is considered as a secured loan; i.e., borrowing using receivables as a collateral. Hence, the amount of the proceeds from the transferor is reported as a liability resulting from a borrowing transaction. In which case, the receivable account remains on the transferor's record. Thus, the only accounting entry required is to record the liability and interest expense involved.

Accounting treatment: when receivables transferred are considered as sales transaction, the following accounts treatments, using the illustration given, are occur.

Illustration: Assume that account receivable with a carrying amount of \$16,800 is sold for \$22,600. If the face amount of the receivable is \$23,000, the transaction would be recorded as follows:

Cash	-----	22600
Allowance for doubtful account (23000-16800)	-----	6200

Accounts receivable -----

23000

Gain on sale of A/R (22600-16800) -----

5800

Associated bad debt expenses in subsequent periods are to be recorded by the factor. The proceeds received from sale of receivables and the amount of transferred receivables that remain uncollected at the end of the accounting period should be disclosed in notes to the transferor's financial statements.

Assignment of receivables: This involves using receivables and collateral for borrowing. The assignor is the borrower whereas the assignee is the lender.

Assignment of accounts receivables requires executing the following accounting activities into the assignor's records:

- i) Amount of assigned accounts receivable would be recorded as **"assigned accounts receivable"** being removed from **"accounts receivable"** account
- ii) Liability is recorded for the principal amount of promissory note signed and cash is recorded for the amount of net proceeds received after the initial interest charge is deducted. The interest fee deducted is to be recorded as interest expense.
- iii) Periodical cash collections from assigned accounts receivable are recorded. These are immediately accompanied with payment to the assignee for periodical interest charges on the unpaid balance and the principal amount of the notes payable.
- iv) Upon settlement of the note in full, when notes payable has zero balance, balance outstanding on "assignee accounts receivable" is converted into "accounts receivable"

To illustrate, assume that on January 2, year 1, **Admas Company** assigned receivables of \$50,000 to **Finco, Inc...** and received \$45,000, less a fee of 2% on the amount advanced. Interest at 1% of the unpaid balance of the loan was to be paid monthly.

The journal entries required in the assignor's accounting records for the problem given above are summarized as follows.

January 1, Year1: Assigned account receivable -----	50,000
Accounts receivable -----	50,000
Cash (45,000-900) -----	44,100
Interest expense -----	900
Notes payable to Finco Inc	45,000

The above entry is for the assignment of accounts receivable by the company (50,000) remitted 90% ($45000 \times 100\%$) of receivables, less 2% fee ($45,000 \times 0.02 = \$900$)

50.000

Assume further that on January 31, year 1, the company received \$30150 from customers and paid the amount to Finco Inc including interest charges.

January 31, year1"	Cash -----	30150
	Assigned account receivable ----	30150

To record cash collection from assigned A/R

Notes payable to Finco, Inc	29700
Interest expense ($45,000 \times 0.01$)	450
Cash -----	30150

This entry is to record payment to the assignee interest expense and retirement of the loan.

Finally assuming that Adams Company collected 17,000 on February 28 from the assigned accounts receivables and paid the balance owed to Finco Inc 1% interest on 153000 unpaid loan all the related records, are shown below

Cash -----	17,000
Assigned accounts receivable ----	17,000

This is to record cash collection from assigned accounts receivable

Computations

Balance due on N/P	----	\$45,000
Interest exp ($1\% \times 45,000$)		<u>450</u>
Collection from assigned N/R		30150
Less: Interest expense		<u>450</u>
Remaining amount to settle		
Principal amount of N/P		<u>297000</u>

2nd month

Computations:

Balance due on N/P (45,000-30150) = 15300

Interest exp (1%X15300) 153

Amount collected from assigned receivables 17000

Interest expense 153

Full settlement of notes payable 15453

Notes payable -Finco Inc 15300

Interest expense 153

Cash 15453

This is to record payment to the assignee: Interest expense and full retirement of the loan.

On February 28, year1, the balance of 'notes payable' is null, thus, journal entry is required to covert or transfer balance in 'assigned accounts receivable' to account receivable as is show (T/account)-the remaining balance is \$28/50 Hence the last entry would be from the ledger

Accounts receivable ----- 2,850

Assigned accounts receivable 2850

Assigned A/R

Jan 1. 50,000	30150 Jan 31
	17000 Feb 28
<u>2850</u>	

Notes Receivables Recognition, Valuation and Disposition

Self Test

1. What is meant by valuation of receivables?
2. Describe a cycle billing system and state its advantage.
3. At what point are trade receivables recorded? Are shipments to consignees recorded as receivables?
4. What meant by disposition of receivable?

5. Explain the disadvantages of the direct written - off method.

Lo2:- Identify bad and doubtful debts

Authorised personnel may include: dispute resolution officer

- employees
- supervisors and managers

Information Sheet - 1 | services on account

Business organizations sell their items or services on cash or on account. It is common for these organizations to sell their items or services on account to increase sales volume. In this case receivables are created. The term receivables include all money claims against people, organizations, or other debtors. Receivables are required by a business enterprise in a various kinds of transactions, the most common being the sale of merchandise or services on a credit sale.

Classification of Receivables

Receivables can be classified broadly as trade receivables and other receivables.

Trade Receivables: are resulted from revenue producing activities such as sale of goods or services. Under this classification examples included are accounts receivable & notes receivable. A promissory note frequently referred to, as a **notes** receivable, is a written promise to pay a sum of money on demand or at a definite time. Notes are more secured than accounts receivables. It is also more liquid (easily changed into cash) than accounts receivable.

Other receivables: are resulted from transactions not directly related to sales. Here included are interest receivables, loans to employees or loans to companies.

Note: that all receivable that are to be collected within a year are presented in the **current asset** section of the balance sheet. Others such as long-term loans are to be listed under **investment** account below the current asset section of the balance sheet.

Controls over Receivables

The control procedures over the receivables include two broad mechanisms:

- a) Separation of the business operations adjustments, such as credit approval, credit collection, credit handling of receivables etc. and the accounting for receivables such as handling of the accounts receivable subsidiary ledger and general ledger; and
- b) Separation of duties for related functions.

Notes Receivable. (A note)

Definition: A note is a written promise to pay a sum of money on demand or at a definite time.

Characteristics: a note has different characteristics that have accounting implications, which are explained in the following ways:

Parties: In notes receivable there are two parties involved. The one to whose order the note is payable (the holder or the receiver of the note) is called the **payee** (the seller); and the one making the promise/ issuer of the note or the buyer is called the **maker**.

Due Date: is the date at which the note is retired or paid. It is also called the **maturity date**.

Issuance date: is the date at which the note is written or issued.

Maturity value: is the amount that is due at the maturity or due date.

$$\text{Maturity value} = \text{Principal} + \text{interest}$$

Types: There are two types of notes. Interest bearing (**Interest = Principal * Rate of interest * Time**) the time period can be expressed in terms of days, months or weeks; and non-interest bearing which has no interest on it but other indirect charges may be there.

To illustrate the above characteristics consider the following examples:

- a) Br.10,000, 10% interest, 120 days note dated March 16.
- b) Br.12,000, 10% interest, 4 months note dated June 5.

Required: calculate the interest, the maturity value and determine the due date of each note.

Solution: a) $\text{Interest} = \text{Principal} * \text{Rate} * \text{Time}$

$$= \text{Br.10,000} * 10\% * \frac{120 \text{ days}}{360 \text{ days}} = \text{Br.333.30}$$

$$\text{Maturity value} = \text{Principal} + \text{Interest}$$

$$= \text{Br.}10,000 + 333.33 = \text{Br.}\underline{10,333.33}$$

Due date: Term of the note.....

120 days

Days in March 31

Less: Term date (issuance date) 16 15

105 days

Days in April..... 30

Days in May 31

Days in June 30

Total 91 days

The due date is July 14

Remark:

January is a month of 31 days

February is a month of 28 days

March is a month of 31 days

April is a month of 30 days

May is a month of 31 days

June is a month of 30 days

July is a month of 31 days

August is a month of 31 days

September is a month of 30 days

October is a month of 31 days

November is a month of 30 days

December is a month of 31 day

b) $I = P * R * T$

$$= 12,000 * \frac{12}{100} * \frac{4 \text{ months}}{12 \text{ months}} = \underline{\text{Br. } 480}$$

$$\text{Maturity value} = P + I$$

$$= \text{Br.}12,000 + \text{Br. } 480 = \text{Br.}12,480$$

Due date: June6 - July5 = 1 month

July 6 - Augusts = 1 month

August 6 - September 5 = 1 month

September 6 - October 5 = 1 month
4 months

Therefore, the due date is October 5.

Lo3:	Review compliance with terms and conditions and plan recovery action
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Information provided to customer may include descriptions of:

- accounts geared to the needs of particular groups such as:
 - customer deeming accounts
 - youth accounts
- investment accounts
- retirement accounts
- savings accounts.

Accounting for Receivables

In a business organization notes may be received or created when:

- Items/ services are sold on long-term credit, usually greater than 90-days.
- Cash is lent to an entity (individuals, business organizations etc.).
- The account of a customer becomes delinquent (a delinquent accounts receivable is an account receivable which is not paid on its last payment date and changed to notes receivable).

When a note is received from a customer to apply on account, the facts are recorded by debiting the notes receivable account and crediting the accounts receivable controlling account (delinquent account) and the account of the customer from whom the note is received.

Example: Assume that the account of Glenn Enterprise, which has a balance of Br.9,200, is past due (delinquent). A 90 -day non-interest bearing note for that amount dated May 16,1990, is accepted in settlement of the account. The notes receivable is recorded at its face value and the entry to record the transaction is as follows.

May 16. Notes Receivable 9200
 Accounts Receivable 9200

When the amount is collected on the due date (August 14)

Cash 9200
 Notes Receivable 9200

Interest bearing note: If a note received from a customer on account is interest bearing, interest must be recorded as appropriate.

ASSIGNMENT

1. assume that the account of X-company that has a debit balance of Br.6,000 is past due. A 30 -day, 12% note for that amount dated December 31, 2001 is accepted in settlement of the account. Assume the end of the year is December 31, 2001. Assume a 360- days year.

Required: a) Determine the due date

b) Prepare journal entries to record

2. What is meant by valuation of receivables?
3. Describe a cycle billing system and state its advantage.
4. At what point are trade receivables recorded? Are shipments to consignees recorded as receivables?
5. What meant by disposition of receivable?
6. Explain the disadvantages of the direct written - off method.

Lo3:

Review compliance with terms and conditions and plan recovery action

- **Information required for opening accounts** may include: amount of initial deposit
- other signatories to the account
- primary account holder's:

Address Lo3:- Review compliance with terms and conditions and plan recovery action



➤ contact details

- purpose for which the account will be used
- required links to other accounts held.

Discounting Notes Receivable

If the holder of the note is in need of more funds/ cash for current operation, it may be endorsed or transferred to a bank or any financial agency. This process is called discounting notes receivable.

When a note is discounted at bank, the bank charges an interest on the maturity value of the note. This interest is called discount and it is computed using the following formula.

Discount = Maturity value * Discounting rate * Discounting period/time

The amount of money paid to the endorser/ holder of the note who transfers it to the bank because of high need of cash, is called **proceeds/ balance**. It is the excess of the maturity value over the discount, i.e., **Proceeds = Maturity value - Discount**.

To illustrate a discounting notes receivable, assume that a 90-day, 12% notes receivable for Br.1800, dated November 8, 2001, is discounted at the bank on December 31, 2001 at the discounting rate of 14%. Assume a 360-days year.

Required:

- 1) Determine the due date, discounting period, Interest, the discount, maturity value, and proceeds.
- 2) Prepare entries to record discounting of the note.

Solution:

1) Interest = Principal * Rate * Time

$$= \text{Br. } 1800 * 12\% * \frac{90 \text{ days}}{360} = \text{Br. } \underline{54}$$

Maturity value = Principal + interest

$$= \text{Br. } 1800 + \text{Br. } 54 = \text{Br. } \underline{1854}$$

Due date = Terms 90 days

Days in November (30-8) 22

Days in December 31

Days in January 31 84

Due date is **February** 6

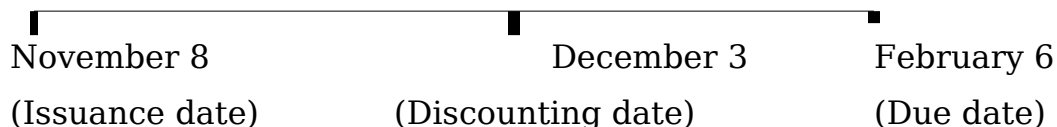
Discount period:

December (31-3) 28

January 31

February 6

65 days



Discount = Maturity value * Discounting rate * Discounting period
= Br. 1854 * 14% * 65/360 = Br. 46.87 this is the amount to the bank as an interest.

Proceeds = Maturity value - Discount

= Br. 1854 - Br. 46.87 = Br. 1807.13 this is the amount the holder of the note will receive from the bank in exchange of the note.

2) Entries on December 3, when the note is endorsed to the bank is (to record the proceeds)

Cash	Br. 1807.13	
Notes Receivable		1800
Interest income (Br.54 - Br. 46.87) ...		7.13

Note that if the proceeds are greater than the face value of the note, there will be **an interest income to the organization. Otherwise, there will be interest expense.** Or if the interest is **greater** than the discount the difference is interest income to the discounting notes but if the interest is less than the discount the difference is charged to interest expense account to the organization, which discounts the note at bank.

Dishonored notes

In business organizations, the maker of the note may fail to pay the debt on the due date. Here, in this case, the note is said dishonored, which is not longer negotiable or transferable. For this reason the holder usually transfers the claim, including any interest due, to the accounts receivable. To illustrate this fact, assume a Br. 12,000, 30-days, 12% notes receivable on December 31, 2001, had been dishonored at the due date (January 20, 2002)

Required: 1) Calculate the maturity value.

2) Record entries occurred on the issuance date and maturity date?

Solutions:

1) Interest = Br.12,000 * 12% * 30/360 = Br.120

Maturity value = Br.12,000 + Br.120 = Br.12,120

2) Entries on the issuance date (December 21, 2001)

Notes Receivable	Br. 12,000	
Accounts Receivable		Br. 12,000

Entries on the maturity Date (January 20, 2002)

Accounts Receivable	Br. 12,120
Notes Receivable	12,000

Dishonored Discounted notes

When a discounted note receivable is dishonored, the holder usually notifies the endorser of such fact and asks for payment. If the request for payment and notification of dishonor are timely, the endorser is legally obligated to pay the amount due on the note. The entire amount paid to the holder by the endorser, including interest, should be debited to the account receivable of the maker.

To illustrate this fact assume that a 60-day, 12% Br. 42,00 note dated November 8, 2001, discounted on December 3, 2001 at 14% discounting rate is dishonored at maturity by the maker. Assume, the bank charged Br.50 as penalty for the failure (**called protest fee**). Assume further a 360-days accounting year ending on December.

Required: Record all the necessary transactions & compute all the amounts required.

Due date:

Solutions: Term period	60 days
Days in November (30-8)	<u>22</u>
	38
Days in December	<u>31</u>
January 7 is the due date	<u>7</u>

Discounting period:

Days in December (31-3)	28
January	<u>7</u>
	<u>35</u> day

$$\text{Interest} = \text{Br. } 42,000 * 12\% * 60/360 = \text{Br. } \underline{840}$$

$$\text{Maturity value} = \text{Br. } 42,000 + \text{Br. } 840 = \text{Br. } \underline{42,840}$$

$$\text{Discount} = \text{Br. } 42,840 * 14\% * 35/360 = \text{Br. } \underline{583.10}$$

$$\text{Proceeds} = \text{Br. } 42,840 - \text{Br. } 583.10 = \text{Br. } \underline{42,256.90}$$

Entries: On November 8 (issuance date:

Notes Receivable Br. 42,000

Accounts Receivable Br. 42,000

On December 3, 2001 to record the proceeds.

Cash	Br. 42,256.90
Notes Receivable	Br. 42,000
Interest income	256.90

On January 7, 2002, to record the dishonored discounted note.

Accounts Receivable (42,840 + 50)	42,890
Notes Receivable	42,890

Information Sheet

Organisational procedures for customer identification may include:	• conducting the 100 point check of personal identification • Identifying and matching customer with existing accounts held within own financial institution.
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Uncollectible Receivables

Regardless of the care used in granting credit and the effectiveness of collection procedures used, a part of the claims against customers usually proved to be uncollectible. This could be because of bankruptcy, closing of the debtors business or failure of repeated attempts to collect. In any way, the operating expense incurred because of the failure to collect receivables is **called an expense /a loss from uncollectible accounts/ doubtful accounts or bad debt Expense.**

There are two methods of accounting for receivables that are believed to be uncollectible.

- a) The allowance method (reserve method)
- b) The direct write-off (direct charge-off method)

A) **The allowance method:** This method provides in advance for uncollectible receivables. The advance provision or estimation for future uncollectibility is made by an adjusting entry at the end of the fiscal year. It reduces the value of receivables to the amount of cash expected to be realizable from customers in future. It matches current expense with current revenue.

Example: ABC-company started its operation on January 1, 2001 and chooses to use the calendar year as its fiscal year. The accounts receivable, has a balance of Br. 200,000 at the end of the period in total.

At this period no specific accounts are believed to be wholly uncollectible. But it seems likely that some will be collected only in part and that others are likely to become worthless.

Assume based on a careful study, it is estimated that a total of Br. 8000 will eventually proved to be uncollectible. Then,

- i) What is the expected realizable accounts Receivable.
- ii) Journalize the entry to record the estimated bad debt expense
- iii) what do you think will be the effect of not recording such corrections?

Solution:

i) Net realizable value = Br. 200,000 - Br. 8000 = Br. 192,000

ii) Bad debt expense Br. 8000

Allowance for uncollectible..... Br. 8000

The bad debt expense is reported on the income statement but the allowance for uncollectible is reported on the balance sheet as contra of accounts receivable.

iii) The effect is understating expenses and overstatement of net income, capital and asset amounts.

Note that the Br. 8000 reduction in accounts receivable cannot yet be identified with a specific customer accounts in the subsidiary ledger and should, therefore, not be credited to accounts receivable but to allowance for doubtful account, which is a contra asset account.

Write-offs to the allowance account.

When an account is believed to be uncollectible, the amount is transferred from the allowance for doubtful account to the accounts receivable.

Self check

1., assume Br. 2000 of the accounts receivable of customer - x of ABC company has been determined to be uncollectible during 2002. The adjusting entry to write-off the allowance would be:

2. If an accounts receivable that has been written-off against the allowance account is later collected, the account should be re-instated by an entry that is exact reverse of the write-offs entry:

Assume that ABC company's customer-x has paid the Br.2000. Record the entry.

Lo4:

Prepare reports and file documentation

This is entry to record collection of cash

The accuracy and sufficiency of information provided includes ensuring:	• authenticity of signatures • checks against or links to existing customer account information • completeness of documentation • provision of sufficient documentary evidence (points) to meet the requirements for establishing a new account
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Estimating uncollectibles

The estimates of uncollectibles at the end of the fiscal period is based on **past experiences** and **forecasts of future** business activities. It is based on either:

- The amount of sales for the entire period (**called an income statement approach**) or
- The amount and age of receivables account at the end of the fiscal period. (**called balancesheet approach**).

a) Income statement approach:

Formula:

Estimated = Net credit sales * Percentage of estimated

Bad debt expense to be uncollectible.

- The amount of this estimate is added to whatever balance exists in the allowance for doubtful account.

Examples: Assume net credit sales on December 31, 2001 for ABC organization is Br.200, 000, estimated uncollectible
1.5%

Required: Record the entry

Bad debt expenses (200,000 * 1.5%) 3000

Allowance for uncollectible 3000

- c) **Balance sheet approach:** The process of analyzing the receivable accounts in terms of the length of time past due is sometimes called **aging of the receivable**. The due date of the account is the base point for determining age. In this method accounts are categorized individually based on the length of time they have been outstanding and apply the expected percentage of uncollectible.

Example: At the end of 2001 accounts receivable ledger of ABC company has the balance of Br.200, 000 which can be categorized as follows:

Age group amount of	amount	Estimated percentage of uncollectible	Estimated uncollectible
	(a)	(b)	C = a * b
Not yet due	Br. 80,000	0.5%	Br. 400
1-30 days past due	25,000	1%	250
31-60 days past due	20,000	2%	400
61-120 days past due	60,000	5%	3000
More than 120 days past due	<u>15,000</u>	20%	<u>3000</u>
	<u>Br.200,000</u>		<u>Br.7050</u>

The Br.7050 amount is the desired balance of allowance account after adjustment; and to be deducted from accounts receivable to determine the net realizable value. Assuming that the allowance for uncollectible account had no balance, the entry to record this new amount is:

Bad debt expense..... Br.7050

Allowance for uncollectible..... Br.7050

Note that if the allowance account has a debit or credit balance before adjustment, it must be considered accordingly when the base of the estimation is the balance sheet approach.

B) Direct write off, method

Under this method of accounting for receivables no valuation of allowance for accounts receivable is used. The business recognizes no uncollectible account expense until specific receivables are determined to be worthless. Thus, receivables are not stated at net realizable value. This method lacks to follow the matching principle.

The entry to record the write-off the uncollectible account is:

Bad debt expense xxx

Accounts receivable xxx

To record the recovery of accounts previously written-off is:

Accounting receivable xxx

Bad debt expense..... xxx and

Cash..... xxx

Accounts receivable xxx

Transaction processing may be:	• manual or electronic and may involve: ➤ accurate data entry of transactions into relevant database ➤ accurate completion of customer application forms and transaction receipts
---	---

Customer **account** details may include Electronic Fund Transfer disputes

- electronic bill and other payments
- fees charged
- insurance
- investment, retirement savings
- payroll:
 - member chequeing
 - direct debit
- periodical payments
- transfers from other accounts
- visas and other plastic cards.

Required information to transfer or close an account may	• account details to enable transfer of remaining funds • details of possible complaints relating to the account • reasons for transfer or closure of accounts
---	--

include:	
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Self check

- 1) assume Br. 2000 of the accounts receivable of customer - x of ABC company has been determined to be uncollectible during 2002.

Required : The adjusting entry to write-off the allowance would be:

- 2) Assume that ABC company's customer-x has paid the Br.2000. Record the entry.

Required : prepare the necessary journal entries

- 3) ABC-company started its operation on January 1, 2001 and chooses to use the calendar year as its fiscal year. The accounts receivable, has a balance of Br. 200,000 at the end of the period in total.

At this period no specific accounts are believed to be wholly uncollectible. But it seems likely that some will be collected only in part and that others are likely to become worthless.

Assume based on a careful study, it is estimated that a total of Br. 8000 will eventually proved to be uncollectible. Then,

- i) What is the expected realizable accounts Receivable.
- ii) Journalize the entry to record the estimated bad debt expense
- iii) what do you think will be the effect of not recording such corrections?

Lo5:- Distribute creditor's invoices for authorization

Information Sheet: - Accounting System and Internal Control

Effective internal control over sale of goods and related cash collections are integral parts of the system for handling trade accounts receivable. For effective handling of receivables the following mechanisms should be applied in a business organization:

Segregation of duties: This means separation of responsibilities in a business firm. An individual who is assigned for recording sales and collection of trade receivables should not be assigned in handling cash receipts or in preparing bank deposit slips.

Cycle billing:- It is a procedures that insures timely collection of receivables and it involves billing customer as different time schedules after getting customers classified on different basis such as geographic location or type of customer.

Accounting Activities for Trade Receivables

In trade receivables the following major activities are treated:

- Recognition of receivables
- Valuation of receivables
- Disposition of receivables

Recognition of receivables: In recording trade accounts receivables the following two questions should be answered.

1. At what point in the earning process should a trade accounts receivable be recorded? And
- 2, How should the net amount of a trade accounts receivable be measured so that related asset, revenue and expense accounts will be accounted accurately?

The answer for question No. 1 is: Trade accounts receivable is recorded when sales are made and title to the goods is transferred to the buyer, i.e., at the point of sale. It should be noted hat when customer order is received, goods are produced or when goods are shipped on consignment receivables should not be recorded or recognized. However, receivables may be recorded for work completed on construction type contracts. This is congruent with revenue recognition for long-term project under percentage completion method.

In recording/ recognizing receivables the following factors should be taken into consideration.

- ❖ Trade discount
- ❖ Cash/sales discount
- ❖ Estimated collection costs for receivables
- ❖ Sales returns and allowance
- ❖ Allowance for fright-out (Transportation costs)
- ❖ Sales tax

❖ Container deposits (Cash Debit and Credit container deposit liabilities)

Valuation of receivables: It involves determining the net realizable value (present value) of claims from customers considering the amount due and the estimate of the probability that the receivable will be collected. This process recognizes doubtful account expense or bad debt expense related to non-collectability of receivable. Receivables that will never be collected have a zero value, and the related revenue will not be realized. Thus, the major objective of estimating this doubtful account is to prevent an overestimate of assets and revenue in the accounting period in which the sales is made.

Two accounting methods may be adopted to account for doubtful accounts.

a. Allowance method or reserve method

b. Direct-write-off method or direct charge of method.

c. Allowance method: Under this method, adjustments are made at the end of each accounting period in order to estimate the amount of receivable that is probable to be unelectable. An account called allowance for doubtful account is used and the adjusting entry at the end of the year for this method is presented as follows:

Doubtful account expense -----	xxx
Allowance for doubtful account -----	xxx

The objective of this adjustment is to prevent overstatement of assets and revenues in the period in which the sales is made.

The net realizable value (carrying amount) of trade accounts receivable which is reported on the balance sheet is calculated as follows:

NRV of A/R	=	Accounts	-	Balance of valuation
(carrying amount)		receivable (gross)		allowance

(after adjustment)

The doubtful account expense recorded may be reported in the income statement as operating expense (most commonly used practice) or as other non-operating expense or as a deduction from sales.

Illustration: Account balance of accounts receivable for **pear trading** at December 31, year 6 is determined to be a positive balance of \$60,000. On the

other hand, allowance for doubtful accounts has a credit balance of \$ 2,000 before adjustment and 5% of accounts receivable is estimated to be uncollectible.

Required:

- Compute the total amount of the allowance for doubtful account
- Compute the net realizable value of the receivable
- Record the adjusting entry

Solution: Current provision for doubtful account = (5%) (60000) = 3000

∴ Adjustment amount bad debt expense is: 3000-2000 = 1000

- The net realizable value of the account receivable at the end of the year (December 31, year 6) is \$60,000 - \$3,000 = \$57,000

- The adjusting entry on December 31, year 6 is:

Doubtful account expense (bad debt expense)	-----	1000
Allowance for doubtful account	-----	1000

Note that when a given customer's receivable is manifested uncollectible due to various reasons the account will be written-off as uncollectible and the entry would be:

Allowance for uncollectible account	-----	xxx
Accounts receivable (specific customer)	-----	xxx

This entry has no effect on the net income of the accounting period, on the receivables account and allowance for uncollectible account.

After accounts receivable is written-off, it is possible for organizations to collect the mount written-off either in full or partially. This is called recovery or reinstatement of accounts receivable written-off and the entry would be:

Accounts receivable	-----	xxx
Allowance for doubtful account	----	xxx

 This is to reverse the written of entry

Cash	----	xxx
Accounts receivable	xxx	

 This is to record the collection of cash

Illustration: Assume that Pear Trading, in the above illustration, write off a customer's account that is considered to be uncollectible for \$ 670. Assume,

further that \$450 cash is collected from the customer whole account had been written of (670)

Required: Record the necessary entries

Solution: Allowance for doubtful account ---- 670

Accounts receivable ---- 670

This is to record the written-off accounts receivable

Accounts receivable ----- 450

Allowance for accounts receivable ----- 450

To reinstate the customers account

Cash ----- 450

A/R ----- 450

To record the collection

- d. **Direct written-off method:** This is another method of recognizing doubtful account expense. Under this method there is no provision or estimation of uncollectibles for receivables and does not record doubtful accounts beforehand unless specific accounts are identified to be uncollectible. This method is sometimes called **specific write-off method**.

It is only upon discovery of specific receivable determined to be uncollectible, specific customer defaulting, a write-off entry performed to record doubtful account expense and cancel the balance from accounts receivable account with the related account in the subsidiary ledger, i.e., the entry to record when a special customer is found defaulted would be:

Doubtful account expense ----- xxxx

Accounts receivable ----- xxxx

Under this method, no adjusting entry is required at the end of the period and a valuation allowance account is not maintained for doubtful accounts.

Lo6:- Remit payments to creditors

Information Sheet Recover of written-off Accounts Receivable

Under the direct-written-off method, similar to the case in the allowance method, when an amount is, either partially or in full, collected there are two entries recorded.

- iii) when the amount is recovered in the same period in which it is written-off; where the doubtful account is not yet closed the entry would be:

Account receivable	-----	xxx
Doubtful account expense	-----	xxx
To record the reversal entry		
Cash	-----	xxx
A/R	-----	xxx
To record the collection of cash		

- iv) When the amount is recovered in subsequent periods after it is written-off it is common to credit “doubtful account recovered” account for the balance recovered. This accounts is reported separately in the income statement as other revenue. The journal entry follows are:

Account receivable	-----	xxx
Doubtful account recovered	-----	xxx

This is to record the recovered amount after it was written-off in one period and recovered in another period.

Cash	-----	xxx
Account receivable	-----	xxx

This is to record the collection.

Even if the direct write-off method appears simple and convenient, it has the following limitations

- It makes no matching of doubtful account expense with current period revenue.
- It overstates the carrying amount of receivables.

Disposition of receivables

Disposition of receivables are financing transactions that are commonly used as a source of cash. It shortens the operating cycle and avoids short-run cash flow problems instead of waiting until customers pay their accounts. Conversion of accounts receivables into cash may be facilitated through three means:

- ❖ Selling receivable

- ❖ Pledging receivables as collateral for loans
- ❖ Assigning receivables

Enterprises engaged in the buying of receivables are known as **factors**, and the process of selling receivables is called **factoring**. Factors generally buy receivables outright, that is, without recourse. Alternatively, factors or other lending institutions may buy receivables with recourse, or may lend money to the owner of the receivables under a legal arrangement known as **assignment**. In such cases customers generally are instructed to make payments directly to the factors or other lenders. Factoring is an important source of ready cash in different types of business enterprises.

A pledge of accounts receivable as a collateral for a loan involves no special accounting problems. Accounting for the sale and the assignment of account receivable is described in the following sections.

Lo7:- Prepare accounts paid report and reconcile balances outstanding
Information Sheet Notes Receivables Recognition, Valuation And Disposition

Sale of Receivables

Factoring of receivables involves selling receivables to a third party. Two parties are involved with the transactions: **Transferor** (one who transfers the receivables) and **Transferee** (the factor or lending institution).

Sale of receivables can happen in two ways:

Without recourse: This involves the shifting of the risk of credit losses, the effort of collection and the waiting period that result from the granting of credit to the purchaser of the receivables. But, sales returns and sales discount, issues are to be considered by the transferor.

With recourse basis: when receivables are sold with recourse, the seller (transferor) in effect guarantees the receivables, and the purchaser (transferee) is reimbursed for failure of debtors to pay the full amount anticipated at the time of sale.

This type of transfer is accounted and reported as sale of accounts receivable only when all of the following three conditions are met:

- ❖ The transferor surrenders control of the future economic benefits of the receivables; i.e., the transferor does not retain the option to purchase the receivable later.
- ❖ The transferor can estimate the collectability of receivables in the future.
- ❖ The transferee cannot require the transferor to purchase the receivables.

If any of the above condition is not met, the transferor is considered as a secured loan; i.e., borrowing using receivables as a collateral. Hence, the amount of the proceeds from the transferor is reported as a liability resulting from a borrowing transaction. In which case, the receivable account remains on the transferor's record. Thus, the only accounting entry required is to record the liability and interest expense involved.

Accounting treatment: when receivables transferred are considered as sales transaction, the following accounts treatments, using the illustration given, are occur.

Illustration: Assume that account receivable with a carrying amount of \$16,800 is sold for \$22,600. If the face amount of the receivable is \$23,000, the transaction would be recorded as follows:

Cash	----	22600
Allowance for doubtful account (23000-16800)	----	6200
Accounts receivable	-----	
23000		
Gain on sale of A/R (22600-16800)	----	
5800		

Associated bad debt expenses in subsequent periods are to be recorded by the factor. The proceeds received from sale of receivables and the amount of transferred receivables that remain uncollected at the end of the accounting period should be disclosed in notes to the transferor's financial statements.

Assignment of receivables: This involves using receivables and collateral for borrowing. The assignor is the borrower whereas the assignee is the lender.

Assignment of accounts receivables requires executing the following accounting activities into the assignor's records:

- v) Amount of assigned accounts receivable would be recorded as **"assigned accounts receivable"** being removed from **"accounts receivable"** account
- vi) Liability is recorded for the principal amount of promissory note signed and cash is recorded for the amount of net proceeds received after the initial interest charge is deducted. The interest fee deducted is to be recorded as interest expense.
- vii) Periodical cash collections from assigned accounts receivable are recorded. These are immediately accompanied with payment to the assignee for periodical interest charges on the unpaid balance and the principal amount of the notes payable.
- viii) Upon settlement of the note in full, when notes payable has zero balance, balance outstanding on "assignee accounts receivable" is converted into "accounts receivable"

To illustrate, assume that on January 2, year 1, **Admas Company** assigned receivables of \$50,000 to **Finco, Inc...** and received \$45,000, less a fee of 2% on the amount advanced. Interest at 1% of the unpaid balance of the loan was to be paid monthly.

The journal entries required in the assignor's accounting records for the problem given above are summarized as follows.

January 1, Year1: Assigned account receivable -----	50,000
Accounts receivable -----	50,000
Cash (45,000-900) -----	44,100
Interest expense -----	900
Notes payable to Finco Inc	45,000

The above entry is for the assignment of accounts receivable by the company (50,000) remitted 90% (45000X100%) of receivables, less 2% fee (\$45,000X 0.02= \$900)

50.000

Assume further that on January 31, year 1, the company received \$30150 from customers and paid the amount to Finco Inc including interest charges.

January 31, year1" Cash ----- 30150
 Assigned account receivable ---- 30150

To record cash collection from assigned A/R

Notes payable to Finco, Inc 29700
 Interest expense (\$45,000X0.01) 450
 Cash ----- 30150

This entry is to record payment to the assignee interest expense and retirement of the loan.

Finally assuming that Adams Company collected 17,000 on February 28 from the assigned accounts receivables and paid the balance owed to Finco Inc 1% interest on 153000 unpaid loan all the related records, are shown below

Cash ----- 17,000
 Assigned accounts receivable ---- 17,000

This is to record cash collection from assigned accounts receivable

Computations			
Balance due on N/P	----	\$45,000	
Interest exp (1%X45,000)			<u>450</u>
Collection from assigned N/R		30150	
Less: Interest expense		<u>450</u>	
Remaining amount to settle			
Principal amount of N/P			<u>297000</u>
2 nd month Computations:			
Balance due on N/P (45,000-30150) =	15300		
Interest exp (1%X15300)			<u>153</u>
Amount collected from assigned receivables		17000	
Interest expense		<u>153</u>	
Full settlement of notes payable			<u>15453</u>

Notes payable -Finco Inc 15300
 Interest expense 153

Cash

15453

This is to record payment to the assignee: Interest expense and full retirement of the loan.

On February 28, year1, the balance of 'notes payable' is null, thus, journal entry is required to covert or transfer balance in 'assigned accounts receivable' to account receivable as is show (T/account)-the remaining balance is \$28/50 Hence the last entry would be from the ledger

Accounts receivable ----- 2,850
Assigned accounts receivable 2850

Assigned A/R	
Jan 1. 50,000	30150 Jan 31
	17000 Feb 28
2850	

Self Test

7. What is meant by valuation of receivables?
8. Describe a cycle billing system and state its advantage.
9. At what point are trade receivables recorded? Are shipments to consignees recorded as receivables?
10. What meant by disposition of receivable?
11. Explain the disadvantages of the direct written - off method.