
UNIT 8. ACCOUNTING FOR RECEIVABLES

8.1 INTRODUCTION

In this unit, we emphasize on how companies account for and report receivables. We have discussed the importance of estimating uncollectibles in order to determine the reasonable balance of receivables on the balance sheet.

Most of the companies sell goods and services on credit in order to earn more profits. Receivables represent claims for money, goods, services, and non-cash assets from other firms. Receivables may be current or non-current depending on the expected collection date.

8.2 CLASSIFICATION OF RECEIVABLES

Receivables can be broadly classified into Trade Receivables and Non-trade Receivables. **Trade Receivables** describe amounts owed to the company for goods and services sold in the normal course of business. Non-trade Receivable arise from many other sources, such as advance to employees, interest receivables, rent receivables and loan to affiliated companies. Unless we indicate otherwise, we will assume that all receivables in this unit are trade receivables.

Based on the above broad classification, receivables can be further classified into Account Receivable and Notes Receivables. Account Receivable refers to amounts due from customers for credit sales. These receivables are supported by sales invoices or other documents rather than any formal written promises. Such Account Receivables are normally expected to be collected within relatively short period, such as 30 or 60 days. They are classified on the balance sheet as a current asset. On the other hand, Notes Receivable refers to amounts that customers owe, for which a formal, written instrument of credit has been issued. Notes are usually used for credit periods of more than sixty days and for transactions of relatively large value. Notes may also be used in settlement of an open account and in borrowing or lending money.

8.3 INTERNAL CONTROL OVER RECEIVABLES

The principles of internal control that we saw in chapter 5 are required by organizations to safeguard their assets from any kind of error and misconduct. These control procedures should apply on receivables because they are one of the asset

elements for the organization. For example, the individual responsible for sales should be separate from the individual accounting for the receivables and approving credit. By doing so, the accounting and credit approval functions serve as independent checks on sales. Separation of responsibility for related functions reduces the possibility of errors and misuse of funds.

Adequate control over Accounts Receivable begins with the approval of the sales by a responsible company official or the credit department, after the customer's credit rating has been reviewed. Likewise, adjustments of Account Receivable, such as for sales return and allowance, and sales discount, should be authorized or reviewed by a responsible party. Effective collection procedure should also be established to ensure timely collection of receivables and to minimize losses from uncollectible accounts.

8.4 CHARACTERISTICS OF NOTES RECEIVABLE

A claim supported by a note has some advantages over a claim in the form of an Account Receivable. By signing a note, the debtor recognizes the debt and agrees to pay according to the terms listed. A note is therefore a strong legal claim if there is a court action.

A promissory note is a written promise to pay a sum of money on demand or at a definite time. It is payable to the order of a person or firm or to the bearer or holder of the note. The person or firm that makes the promise signs it. The one to whose order the note is payable is called the ***payee***, and the one making the promise is called the ***maker***.

Notes have several characteristics that affect how they are recorded and reported in the financial statements. The characteristics are described in the following paragraphs:

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- ***Due Date***

The date a note is to be paid is called the **Due Date or Maturity date**. The period of time between the issuance date and the due date of a short-term note may be stated in either days or months. When the term on a note is expressed in days, the maturity date is the specified number of days after the note's date. As an example, a five-day note

dated January-1 matures and is due on January-6. A 90-day note dated March-10, matures on June-8. This due date, June-8, is computed as below: -

Term of the Note-----90

Days in March-----31

Minus the date of the note-----10

Days remaining in March-----21

Add days in April-----30

Add days in May-----31

82

Number of days remaining to equal 90-days

(90 - 82 = 8)-----8

Therefore, Due date is June-8.

The period of a note is sometimes expressed in months. When months are used, the note matures and is payable in the month of its maturity on the same date of the month as its original date

A three-month note dated March-10, for instance, is payable on June-10.

Interest Computation

Interest is the cost of borrowing money for the borrower. It is the profit from lending money for the lender. The interest rate on notes is normally stated in terms of per year, regardless of the actual period of time involved.

The formula for computing interest is as follows: -

$\text{Interest} = \text{Principal} \times \text{Annual} \times \text{Time}$ (Face Amount of the Note) interest Rate
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To illustrate the formula, the interest on a Br. 10,000, 12%, 60 day note is computed as:-

$$\text{Br. 10,000} \times 12\% \times 60/360 = 200$$

N.B. To simplify interest computations for notes with periods expressed in days, it is common to treat a year as having 360 days.

- **Maturity Value**

The amount that is due at the maturity or due date is called the maturity value. The maturity value of a note is the sum of the face amount and the interest. In the above example, the maturity value is Br. 10,200 (which is Br. 10,000 face amount plus Br. 200 interest)

I.e. $MV = FV + I$ where $MV = \text{Maturity value}$
 $FV = \text{Face value}$
 $I = \text{Interest}$

8.5 ACCOUNTING FOR NOTES RECEIVABLE

Notes Receivable are usually recorded in a single note Receivable account to simplify record keeping. We need only one account because the original notes are kept on file. This means the maker; rate of interest, due date, and other information can be learned by examining the actual note.

To illustrate the recording of the receipt of a note, assume that on January-10, Nile Co. sales merchandise on account to Tana Co. and receive a Br. 5,000, 90-day, 12% promissory note.

This transaction is recorded as: -

Jan. 10. Notes Receivable -----5000
 Sales-----5000

The maker of the note usually honors the note and pays it in full. The entry required to record the receipt of cash by Nile Co. from Tana Co. is as follows:

April-10 Cash-----5150
 Notes Receivable-----5000
 Interest Revenue (500 X 12/100 X 90/360)----150

Companies can sometimes accept a note for an overdue customer as a way of granting a time extension on a past-due account Receivable. To illustrate, assume that a 60-day, 10% note dated September 5, 20x1 is accepted by Awash Co. in settlement of the

September 5 N/R-----10, 000
 A/R -----10,000
 Received a note to settle account

When a note's maker is unable or refuses to pay at maturity, the note is dishonored. The act of dishonoring a note doesn't relieve the maker of the obligation to pay. The payee should use every legitimate means to collect. But how do companies report this event? The balance of the Notes Receivable account normally includes only those notes that have not matured. When a note is dishonored, we therefore remove the amount of this note from the Notes Receivable account and charge it back to an Accounts Receivable from its maker. Assume for instance Nile Co., holds a Br. 1000, 12%, 30-day note of Ato Alemu. At maturity, Alemu dishonored the note. Nile Co. records this dishonoring of its N/R, on Oct. 25, as follows:

The above entry records interest of Br. 10, which has been earned, even though the note has been dishonored.

When notes receivable are outstanding at the end of an accounting period, accrued interest is computed and recorded. For example, on December 20, 20x1, Nile Co. accepted a Br. 2000, 60-day, 12% note from a customer in granting an extension of a past-due account. Assuming that the accounting period ends on Dec. 31, the entries to record the receipt of the note, accrued interest, and payment of the note at maturity are shown below: -

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Received note in settlement of A/R

Dec. 31. Interest Receivable-----8

Int. Revenue-----8

Adjusting entry for ace need

Interest, Br. 2000 X 12% X 12/360 = 8

Feb. 17. Cash-----2040

N/R-----2000

Int. Rec.-----8

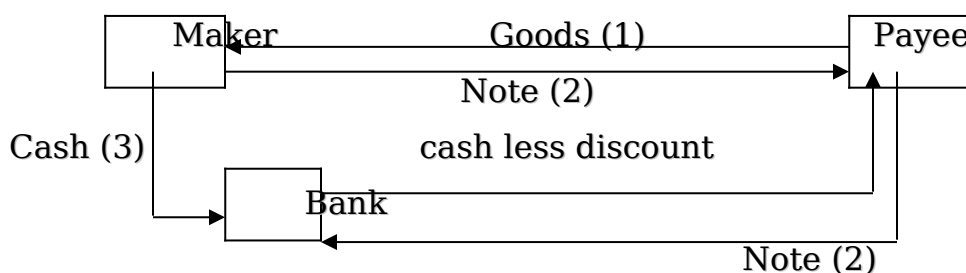
Int. Revenue-----32

Received pyt of note & interest at maturity

The adjusting entry above on Dec. 31, 20X1, was required to show the interest earned for the period on the Income Statement.

8.6 CONVERTING RECEIVABLES TO CASH BEFORE MATURITY

Sometimes, companies convert receivables to cash before they are due. Reasons for this include the need for cash or a desire not to be involved in collection activities. Converting receivable is usually done either (1) by selling them, or (2) by using them as security for a loan. The topic of using notes as security for a loan will be discussed in future courses. Notes Receivable can be converted to cash by discounting them at a financial institution such as a Bank. The process has three steps as indicated in the following diagram. In the first step, the maker receives goods, service or cash from the payee in exchange for the note. In the second step, the payee discounts the note with a bank and receives the maturity value of the note less a discount (a fee) charged by the bank. In the third step, the maker pays the bank at the maturity of the note.



Notes Receivable are discounted with or without recourse. When a note is discounted without recourse, the bank assumes the risk of a bad debt loss and the original payee doesn't have a contingent liability. A contingent liability is an obligation to make a

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future payment if and only if an uncertain future event occurs. A note discounted without recourse is like an outright sale of an asset. If a note is discounted with recourse and the original maker of the note fails to pay the bank when it matures, the payee of the note must pay for it. This means a company discounting a note (an endorser) with recourse has a contingent liability until the bank is paid. A Co. should disclose contingent liabilities in the accompanying notes to its financial statements.

To illustrate, assume that a 90-day, 12%, Br. 20,000 N/R from Hiwot Co. dated Jan.1, 20x2 is discounted at the payee's bank on February 12, 20x2 at the discount rate of 15%. The steps to determine the **proceeds** (-the amount to be received by the payee from the bank upon discounting) are as follows:

Step 1 - Determine the maturity date & maturity value.

$$\begin{aligned}\text{MD} &= \text{April} - 1 \text{ \& } \text{MV} = \text{FV} + \text{I} = 20,000 + [20,000 \times 12\% \times 90/360] \\ &= 20,600\end{aligned}$$

Step 2 - Determine the Bank Discount (**Bank discount** is an interest that is charged by the bank and is computed based on the maturity value of the note for the discount period. **Discount Period** is the time the bank must hold the note) before it becomes due.

➤ Bank Discount = MV X DR X DP where MV = Maturity value (20,600)

DR = Discount Rate (15%)

Discount = 20,600 X 15% X 48/360 DP = Discount period (from
February 12 to April 1)

$$= \underline{412}$$

Step 3- Determine proceed (proceed is the amount of cash paid to the endorser after deducting discount)

$$\text{i.e. proceed} = \text{MV} - \text{D}$$

$$= 20,600 - 412 = 20188$$

Step 4 - Record the necessary journal entry at the date of discount. (Here, record interest

revenue which is the excess of proceeds from the face value or record interest expense when the proceed is less than the face value of the note)

Feb 12. Cash-----	20,188
N/R -----	20,000
I. Rev. -----	188.00
Discounted Br. 20,000, 90-day, 12% note at 15%	

The length of the discount period and the difference between the interest rate and the discount rate determine whether interest expense or interest revenue will result from discounting.

When a discounted Notes Receivable is dishonored, the bank notifies the endorser and asks for payment if there is no statement that limits the responsibility of the endorser. In some cases, the bank may charge a protest fee of notifying the endorser that a note has been dishonored. The entire amount paid to the bank by the endorser, including the interest and protest fee, should be debited to the A/R of the maker. For example, assume that the maker, Hiwot Co, dishonored the above discounted note at maturity. The bank charges a protest fee of Br. 25. The endorser's entry to record the payment to the bank is as follows:

April 2. A/R Hiwot Co-----	20,625
Cash-----	20, 625
Paid dishonored, discounted note	

8.7 ACCOUNTING FOR UNCOLLECTIBLE ACCOUNTS RECEIVABLE

When credit is extended, some amount of uncollectible receivables is generally inevitable regardless of the care taken in granting credit and the control procedures used. The operating expense incurred because of the failure to collect receivables is called Uncollectible Accounts Expense or Bad Debts Expense or Doubtful Accounts Expense.

When does an account as a note become uncollectibles? There is no general rule for determining when an account receivable becomes uncollectible. The fact that a debtor fails to pay an account receivable according to a sales contract or fails to pay a note on the due date does not necessarily mean that the account receivable will be uncollectible. The debtor's bankruptcy is one of the most significant indications of

partial or complete uncollectibility. Other indications include the closing of the customer's business and the failure of repeated attempts to collect.

There are two methods of accounting for uncollectible receivables. The allowance method, which provides an expense for uncollectible receivables in advance of their write-off (removal from the ledger) and the direct write-off method, which recognizes the expense only when accounts receivable are judged to be worthless. We will discuss each of these methods next.

8.7.1 Allowance Method

The allowance method of accounting for bad debts matches the expected loss from uncollectibles A/R against the sales they helped produce. We must use expected losses since management can't exactly identify the customers who won't pay their bills at the time of sale. This means at the end of each period the allowance method requires us to estimate the total bad debts expected to result from that period's sales. An allowance is then recorded for this expected loss. This method has two advantages over the direct write-off method:

- (1) Bad debt expense is charged to the period in which the related sales are recognized, and
- (2) A/R is reported on the Balance Sheet at the estimated amount of cash to be collected.

The allowance method estimates bad debt expense at the end of each accounting period and records it through an adjusting entry. To illustrate this method, assume the A/R account has a balance of Br. 50,000 and based on careful study of the experience of other companies, Nile Co. estimates that a total of Br. 2000 will be uncollectibles.

This estimated expense is recorded through the following adjusting entry.

Dec. 31	Uncollectibles Accounts Expense	2000	
		Allowance for Doubtful Accounts	2000
	To record estimated bad debts		

The amount Br. 2000 is an estimated reduction in A/R; but it cannot be credited to specific customer accounts or to the A/R controlling account. Instead, a contra asset account entitled Allowance for Doubtful Accounts is credited.

As with all periodic adjustments the above entry serves two purposes. First, it reduces the value of the receivable to the amount of cash expected to be realized in the future. This amount, which is Br. 48,000 (Br. 50,000 - Br. 2,000), is called the Net Realizable value of the receivables. Second, the adjusting entry matches the Br. 2000 expense of uncollectibles account with the related revenues of the period.

Write-off to the Allowance Account

When specific accounts are identified as uncollectibles, they are written-off against the Allowance for Doubtful Accounts. Assume after spending some time trying to collect from Shalla Co., Nile Co. decides that Shalla's Br. 200 accounts receivable is uncollectible and makes the following entry to writ-it off.

Jan. 25	Allowance for Doubtful Accounts	200
	A/R-Shalla Co.	200
	To write-off uncollectible accounts.	

Note two aspects of this entry and its related accounts

	Before Write-off	After Write-off
A/R	50,000	49,800
Less Allowance for D. a/cs	2,000	1,800
NRV	<u>48,000</u>	<u>48,000</u>

Neither total assets nor net income are affected by the Write-off of a specific account. But both total assets and net income are affected by the recognized bad debts expense for the year in the adjusting entry.

Recovery of Uncollectibles Accounts

When a customer fails to pay and the account is written-off as uncollectibles, his or her credit standing is jeopardized. To help restore credit standing, a customer may later choose to voluntarily pay all or part of the amount owed. A company makes two entries when collecting an account previously written-off. The first is to reverse the original write-off and reinstate the customer's account. For example, assume the amount written-of in the preceding entry is later collected on February 15.

On Feb. 15- The entries to record this recovery are:

Feb. 15-	A/R Shalla Co.	200
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To reinstate accounts previously written-off

Feb. 15- Cash 200

 A/R-Shalla Co. 200

To record full payment of account

8.7.2 Estimating Uncollectibles

The allowance method of accounting for bad debts requires an estimate of bad debts expense to prepare the adjusting entry at the end of each accounting period. How does a company estimate bad debts expense? There are two common methods. One is based on the Income Statement relationship between bad debts expense and sales. The second is based on the Balance Sheet relationship between A/R and the Allowance for Doubtful Accounts. Both methods require an analysis of past experience.

8.7.2.1 Estimating Based on Sales

Accounts receivable are created by credit sales. The amount of credits sales during the period may therefore be used to estimate the amount of uncollectible accounts expense. The amount of this estimate is added to whatever balance exists in Allowance for Doubtful Accounts. To illustrate, assume Wonji Co. has credit sales of Br. 500,000 in 20X2. Based on past experience and the experience of other Cos, Wonji Co. estimated 0.007% of credit sales are uncollectible. Using this prediction, the adjusting entry for uncollectible accounts at the end of the period, 20X2 is as follows.

Dec. 31 Uncollectibles Accounts Exp. (500,000 X 0.007%) 3500

 Allowance for Doubtful Accounts

3500

To record estimated Uncoll. Exp.

This entry doesn't mean that the Dec. 31, 20X2, balance of Allowance for Doubtful Accounts will be Br. 3500. A Br. 3500 balance results only if the account had a zero balance prior to posting the adjusting entry. For example, assume that Allowance for Doubtful Accounts has a credit balance of Br. 1000 before adjustment. Now, what will be the balance of Allowance for Doubtful Accounts be at the end of 20X2 ? It will be Br. 4500. If there had been a debit balance of Br. 500 in the Allowance for Doubtful Accounts before the year-end adjustment, and the amount of adjustment. would still

have been Br. 3500. What will have been the end balance of Allowance for Doubtful Accounts at the end of 20X2? (Find by your own!)

8.7.2.2 Estimate Based on Analysis of Receivables

The longer an A/R remains outstanding, the less likely that it will be collected. Thus, we can base the estimate of uncollectibles accounts on how long the accounts have been outstanding. For this purpose, we can use a process called Ageing receivables which examines each A/R to estimate the amount of uncollectibles. Receivables are classified by how long they are past their due date. Then, estimates of uncollectibles are made assuming the longer an amount is past due the more likely it is to be uncollectible. After the outstanding amounts are classified and analyzed in the Aging schedule the expected balance for the Allowance for Doubtful Accounts will be estimated. Let's assume the amount estimated is Br. 5000. So, do you think this is the adjustment amount required for the current period? NO!

Because, this estimated amount is the expected balance of the Allowance for Doubtful Accounts after adjustment rather than the current year provision for Uncollectible Accounts Expense. Therefore, to determine the current year provision we must take in to account the balance before adjustment in the Allowance for Doubtful Accounts. To illustrate, assume there is as credit Balance of Br. 1300 in the allowance account before adjustment. The amount to be added to this balance is therefore Br. 3800 (Br. 5000 - Br. 1200) and the adjustment entry is as follows:

Dec. 31	Uncollectible Accounts Expense	3800	
	Allowance for Doubtful Accounts		3800
	To record Uncollectible expense.		

Alternatively, if the Allowance for Doubtful Accounts had an unadjusted debit balance of Br. 700, then the required adjustment is Br. 5700. (Br. 5000 + 700) and the adjustment entry is as follows:

Dec. 31	Uncollectible Accounts Expense	5700	
	Allowance for Doubtful Accounts		5700
	To record Uncollectible expense .		

8.7.3 The Direct- Write-Off Method

The Direct Write-off method of accounting for bad debts records the loss from an uncollectible A/R at the time it is determined to be uncollectible. No attempt is made to predict uncollectible accounts expense. Bad debt expense is recorded when specific accounts are determined to be worthless. If Wonji Co. uses a direct write-off method and determines on Feb. 20, it can't collect from a customer- Home Co.- Br. 500. The entry to write-off the customer's account is as follows

Feb. 20	Uncollectible Accounts Expense	500	
	A/R- Home Co.		500
	To write-off Uncollectible accounts		

Some times an amount previously written off is later collected. This can be due to factors such as continual collection efforts or the good fortune of a customer. If the account of Home Co. that was written-off directly to Bad Debit Expense is later collected in full, the following two entries record this recovery.

Mar. 5 -	A/R- Home Co.	500	
	Uncollectible Accounts Expense		500
	To reinstate account		
Mar. 5 -	Cash	500	
	A/R- Home Co.		500
	To record full payment of account		

If the recovery is in the year following the writ- off, there is no balance in the Uncollectible Accounts Expense account related to the previous year's write-off and no other write-offs are expected. So the credit portion of the entry recording the recovery can be made to a Bad Debts Recoveries revenue account.

To conclude this part companies must weigh at least two principles when considering use of the direct write-off method:

(1) Matching principle, & (2) Materiality principle.