
UNIT 11: ACCOUNTS RECEIVABLE

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11.0 AIMS AND OBJECTIVES

This unit aims at discussing and illustrating one of the primary liquid assets of a business enterprise, accounts receivable. The chapter places emphasis on trade receivables.

After studying this unit, you should be able to:

- know the conditions under which accounts receivables may be recorded.
- understand adjustments to accounts receivables, including uncollectibles accounts, discounts, and returns and allowances
- determine when the transfer of a receivable is reported as a sale or a liability

11.1 INTRODUCTION

The balance sheet of every business enterprise includes a variety of claims from other parties that generally provide a future flow of cash. These 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. Accounts receivable are often supported only by a sales invoice. Trade receivables describe amounts owed the company for goods and services sold in the normal course of business. Non-trade receivables arise from many other sources, such as tax refunds, contracts, investors, finance receivables, installment notes, sale of assets, and advances to employees.

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 losses. Consequently, strong accounting controls and effective management of receivables are typical characteristics of most profitable enterprises.

11.2 MEASURING ACCOUNTS RECEIVABLE

Accounts receivable are recognized only when the criteria for recognition are fulfilled. They are valued at the original exchange price between the firm and the outside party, less adjustments for cash discounts, sales returns and allowances, trade discounts and uncollectibles accounts yielding an approximation to net realizable value, the amount of cash expected to be collected.

1. Trade Discounts

Typically, a single invoice price for a product is published. Then, several different discounts may apply, depending on customer type and quantity ordered. These trade discounts reduce the final sales price and are not affected by date of payment.

Example: Assume an item priced Br. 50 is offered at a trade discount of 40 percent for order over 1000 units. The unit price for an order of 1,100 units is therefore Br. 30 ($\text{Br. } 50 \times 0.6$). The percentage discount can be changed for different order quantities without changing the basic Br. 50 price.

For accounting purposes, the listed invoice price less the trade discount is treated as the gross price to which cash discounts apply. Trade discounts are not accounted for separately, but rather help define the invoice price.

2. Cash Discounts

Companies frequently offer a cash discount for payment received within a designated period. Cash discounts are used to increase sales, to encourage early payment by the customer, and to increase the likelihood of collection. Typical sales terms are 2/10, n/30. That is, the customer is given a 2 percent cash discount if payment is made within 10 days from sale; otherwise, the full amount net of any returns or allowances is due in 30 days.

The incentive to pay within the discount period is generally significant although in percentage terms this does not always appear to be the case.

Example: Ethio company purchased merchandise with a Br. 1000 gross sales price on 2/10, n/30 terms. Ethio decides to settle on the 30th day following the sale, paying Br. 1000 without taking advantage of the Br. 20 cash discount available. Although this decision to delay

payment cost Ethio Br. 20, the annualized interest rate it pays is 37.2%! it is computed as follows:

$$\frac{0.02(\text{Br.}1000)}{980} \times \frac{365}{20} = 37.2\%$$

The Br. 20 “interest” or amount of discount lost paid by Ethio, is slightly over 2 percent of Br. 980, a “principal” amount which would have satisfied the seller if paid within the discount period. This rate was paid for a “borrowing” period of only 20 days, however. The factor 365/20 represents the number of 20-day periods in a year, which yields the substantial annualized rate. Few investments can offer such a rate of return, so most buyers benefit by paying within the discount period. A well designed accounting information system signals the accounts payable staff to pay bills within the discount period.

Gross and Net Methods

When cash discounts are offered, the receivable and sell is recorded either at the gross or net amount (gross invoice less available cash discount). The key distinction between the two is the treatment of sales discounts. The gross method records sales discounts only if the customer pays within the discount period. The net amount records sales discounts only if the customer fails to pay within the discount period.

To illustrate the two methods, assume that Cock Company sells merchandise to Ethio Company at a gross sales price of Br. 1000. Credit terms are 2/10, n/30. Cock company’s entries for selected events follow.

Entry to record credit sale:

	Gross method	Net
method		

Accounts receivable	1000	Accounts
receivable 980		
Sales		1000
Sales 980		

Cock Company's offer of a cash discount supports the net valuation of sales and accounts receivable. Cock Company is satisfied with Br. 980 if payment is made within 10 days of sale. Therefore, the additional Br.20 is a finance charge for delaying payment.

Entry to record collection within the 10-day discount period:

	Gross method	Net
method		
Cash 9-----80		Cash -----980
Sales discount -----20		Accounts
receivable ----980		
Accounts receivable -----1000		

Sales discount is a contra account to sales, reducing net sales by the amount of cash discount taken. The gross method specifically identifies discounts taken by customers.

Entry to record collection after the 10-day discount period:

	Gross method	Net
method		
Cash -----1000		Cash -----1000
Accounts receivable -----1000		Accounts
receivable -----980		
		Sales
discount forfeited ----980		

Sales are measured at the gross price under the gross method when collection is received after the end of the discount period. The date of payment affects the amount of recorded sales under this method

because the finance charge is included in sales if the gross price is paid.

Sales discount forfeited, a revenue account, is similar to interest revenue. The net method specifically identifies discounts forfeited by customers. Regardless of the payment date, the net method reports sales and receivable at the net amount, the amount acceptable to the seller for compute payment.

Under the gross method, if a material amount of cash discount is expected to be taken on outstanding accounts receivable at year-end, and if this amount can be estimated reliably, an adjusting entry is required to decrease net sales and accounts receivable to the estimated amount collectible. To illustrate, assume that Cock Company has Br. 2 million of accounts receivable, all on 2/10, n/30 terms, recorded at gross at year-end and expects 60 percent of these accounts to be collected within the discount period. Cock Company records an adjusting entry on December 31, 1992:

Gross method

Sales discounts (Br. 2,000,000 x 0.02 x 0.6) -----	24,000
Allowance for sales discounts -----	
24,000	

The allowance account is a contra account to accounts receivable. During 1993, assuming that the estimates were correct, a summary entry records the relevant receipts:

Gross method

Allowance for sales discounts -----	24,000
Cash -----	1,176,000
Account receivable (Br. 2,000,000 x 0.6) -----	1,200,000

A material discrepancy between estimated and actual discounts taken is treated as a charge in accounting estimate and may affect future estimates of sales discounts.

Under the net method, if the discount period on a material amount of accounts receivable has lapsed, an adjusting entry is required to recognize forfeited discounts and increase accounts receivable. For example, assume that at the end of 1992, Cock Company has Br. 980,000 of accounts receivable recorded at net on which the discount period has lapsed. Assuming 2/10, n/30 terms, an adjusting entry is made on December 31, 1992:

Net method	
Account receivable (Br. $\frac{980000}{0.98} \times 0.02$) -----	20,000
Sales discount forfeited -----	
20,000	

If proper adjusting entries are made, both methods yield similar results. In practice, adjusting entries for sales discounts are not common when the relevant amounts from year to year are similar.

3. Sales Returns and Allowances

Return privileges are frequently part of a comprehensive marketing program required to maintain competitiveness. Sales returns are unacceptable merchandise taken back; sales allowance are price reductions made to encourage customers to keep merchandise not meeting their preference or having minor damage. Sales returns can be substantial.

Sales returns and allowances reduce both net accounts receivable and net sales. Assume that Nyala Company grants Br. 16,000 of returns and allowances in 1992, the first year of operations. The summary

entry to record actual returns and allowances during the year is the following :

Sales returns and allowances -----	16,000
Accounts receivable -----	
16,000	

Under certain conditions, Nyala must also estimate and recognize the remaining returns and allowances expected for 1992. Assume that total estimated sales returns and allowances are 2% of the Br. 1 million sales for 1992.

Nyala records an adjusting entry on December 31,1992:

Sales returns and allowances (Br. 1,000,000 x 0.02) - (Br. 16,000) -----	4000
Allowance for sales returns and allowances -----	4000

The allowance account is contra to accounts receivable. The effect of the two entries in this example is to reduce 1992 net sales and accounts receivable by Br. 20,000, the total estimated returns and allowances on sales during 1992. In 1993, assuming that the estimates were correct, an entry records returns and allowances on 1992 sales:

Allowance for sales returns and allowances -----	4000
Account receivable -----	4000

A material discrepancy between estimated and actual returns and allowances is treated as a change in accounting estimate and may affect future estimates. If returns and allowances are either immaterial or relatively stable across periods, companies often do not estimate returns and allowances at year-end.

4. Allowance for freight-out

Occasionally goods are sold with the understanding that a customer will pay the freight charges and then deduct that amount from the remittance. In such instances both accounts receivable and sales may be recorded net of the freight charges. Alternatively, both accounts receivable and sales may be recorded at gross amount billed to the customer, along with a debit to Freight-out and a credit to Allowance for Freight-out. The balance in the allowance account is deducted from accounts receivable in the balance sheet.

5. Sales and Excise Taxes

Many government units impose sales and Excise taxes on particular products or on sales transactions. Usually, the seller is responsible for the remittance of these taxes to the government. An excise tax imposed on the manufacture of a product is a part of the cost of production, but an excise tax on the sale of the product is imposed on the purchaser and is collected by the seller.

It sales and excise taxes are collected as separately disclosed additions to the selling price they should not be confused with revenue but should be credited to a liability account. Whether this is done at the time of each sale or as an adjustment at the end of the accounting period is a matter of convenience. Generally, it is preferable to record the liability at the time of sale. For example, if a day's sales amount to Br. 20,000 and are subject to a 6% sales tax, the sales tax payable is Br. 1200, and the journal entry to record sales is:

Account Receivable (cash) (Br. 20,000 x 1.06) -----	21,200
Sales tax payable (Br. 20,000 x 0.06) -----	
1200	
Sales -----	20,000

Check your progress - 1

- Why companies offer cash discount?

-
-
- ii. What is the nature of allowance for sales returns and allowances account?
-
-

11.3 MEASUREMENT OF UNCOLLECTIBLE ACCOUNTS RECEIVABLE

When credit is extended, some amount of uncollectible receivables is generally inevitable. Firms attempt to develop a credit policy neither too conservative (leading to excessive lost sales) nor too liberal (leading to excessive uncollectibles accounts). Past records of payment and the financial condition and income of customers are key inputs to the credit-granting decision.

Two general approaches to recognizing the cost of uncollectibles receivables are found in practice.

- Allowance method: If uncollectibles accounts receivable are both probable and estimatable, an estimate of uncollectibles receivables is recognized and net accounts receivables is reduced. The resulting estimated expenses reflect the likely reduction in the value of recorded receivables. This approach reduces earnings before specific accounts are known to be uncollectibles. Estimated uncollectibles are recorded as bad debt expense, an operating expense, Usually classified as a selling expense. Most large firms use this method.
- Direct-write-off method: If uncollectibles accounts are not probable or estimatable, no adjustment to income or receivables is made until specific accounts are considered uncollectibles.

Under the allowance method, an adjusting entry is needed at the end of an accounting period. For example, if a company estimates Br. 9000 of bad debts at year-end, the adjusting entry is as follows:

Bad debt Expense -----	9000
Allowance for doubtful accounts -----	9000

Allowance for doubtful accounts is a contra account to accounts receivable and is used because the identity of specific uncollectibles accounts is unknown at the time of the above entry. A net account receivable (gross accounts receivable less the allowance account) is an estimate of the net realizable value of the receivables.

Two subsequent events must be considered: (1) the write-off of a specific receivable and (2) collection of an account previously written off. The adjusting entry for bad debt expense creates the allowance for doubtful accounts for future uncollectibles accounts. When specific accounts are determined to be collectible, they are removed from the accounts receivable and that part of the allowance is no longer needed. The bad debt estimation entry previously recognized the estimated economic effect of future uncollectibles accounts. Thus, write-offs of specific accounts do not further reduce total assets unless they exceed the estimate.

For example, the following entry is recorded by a company deciding not to pursue collection of NOSO Company's Br. 1000 account:

Allowance for doubtful accounts -----	1000
Accounts receivable- NOSO -----	1000

This write-off entry affects neither income nor the net amount of accounts receivable outstanding. Instead, it is the culmination of the process that began with the adjusting entry to estimate bad debt expense

The write-off entry is recorded only when the likelihood of collection does not support further collection efforts.

When amounts are received on account after a write-off, the write-off entry is reversed to reinstate the receivable and cash collection is recorded. Assume that NOSO Company is able to pay Br. 600 on account some time after the above write-off entry was recorded. These entries are required:

Accounts receivable - NOSO	-----600
Allowance for doubtful accounts	-----600
Cash	-----600
Accounts receivable - NOSO	-----600

The debit and credit to accounts receivable record the partial reinstatement and collection of the account for future reference.

There are two acceptable methods of estimating bad debt expense: sales method (Income statement approach) and the accounts receivable method (Balance sheet approach).

The objective of the sales method is accurate measurement of the expense caused by uncollectibles accounts. The objective of the accounts receivable method is accurate measurement of the net realizable value of accounts receivable. Some companies use both methods. These two methods of estimating bad debt expenses are thoroughly discussed in principles of accounting textbooks, and you are strongly advised to refer back the methods.

Check your progress - 2

1. What are the two methods of accounting for uncollectibles receivables?

11.3.2 Direct Write-off Method

Companies in the first year of operation or in new lines of business may have no basis for estimating uncollectibles in such cases, and when uncollectibles accounts are immaterial, GAAP allows receivables to be written off directly as they become uncollectibles. The entry for the direct write-off of a Br. 2000 account receivable from DAF Company is as follows:

Bad debt Expense -----	2000
Accounts receivable - DAF -----	2000

No adjusting entry is made at the end of an accounting period under the direct write-off method.

The inability to estimate uncollectibles accounts creates several unavailability problems. First, receivables are reported at more than their net realizable value, as it is virtually certain that not all receivables are collectible. Second, the period of write-off is often after the period of sale, violating the matching principle. And third, direct write-off opens the potential for income manipulation by arbitrary selection of the write-off period.

Check your progress - 3

1. Under what circumstances should the direct write-off method for bad debts be used?

_____.

11.4 VALUATION OF ACCOUNTS RECEIVABLES

For most receivables the amount of money to be received and the due date can be reasonably determined. Accountants thus are faced with a

relatively certain future inflow of cash and the problem is to determine the net amount of this inflow.

A number of factors must be considered in the valuation of a prospective cash inflow. One factor is the probability that a receivable actually will be collected. For any specific receivable, the probability of collection might be difficult to establish; however, for a large group of receivables a reliable estimate of collectibility generally can be made. The possible non-collectibility of receivables is an example of a loss contingency because a future event (inability to collect) confirming the loss is probable and the amount of the loss can be reasonably estimated. If the estimate of possible uncollectibles accounts can be made within a range, but no single amount appears to be a better estimate than any other amount within the range, the minimum amount in the range be accrued.

Another factor to be considered in the valuation of accounts receivable is the length of time until collection. The longer the time to maturity the larger is the difference between the maturity value and the present value of accounts receivable. When the time to maturity is long, most contracts between debtors and creditors require the payment of a fair rate of interest, and the present value of such a contract is equal to its face amount. If the time to maturity of account receivable is short, the present value and the amount that will be received on the due date may be ignored. For example, a 30-day unsecured trade account receivable almost always is recorded at its face amount. The difference between present value and face amount of longer-term receivable always should be considered, because this difference may be material.

Check your progress - 4

1. What factors must be considered in the valuation of receivables?

11.5 USE OF ACCOUNTS RECEIVABLE AS A SOURCE OF CASH

Business enterprises generally raise the cash needed for current operation through the collection of accounts receivable. It is possible to accelerate this process by

- 1) Selling receivables (Factoring)
- 2) Assigning receivables
- 3) Pledging receivables as collateral for loans.

Using accounts receivables to obtain financing effectively shorten the operating cycle, hastens the return of cash to productive purposes, and alleviates short-run cash flow problems. The costs of these arrangements include initial fees and interest on loans collateralized by the receivables. Also, certain risks may be retained by the seller, including bearing the cost of bad debts, cash discounts, and sales returns and allowances.

Agreements to transfer accounts receivables are made on a recourse or non-recourse basis. In recourse financing arrangements, the transferee can collect from the transferor if the original debtor (customer) fails to pay. If the arrangement is without recourse, the transferee assumes the risk of collection losses. The fee is higher under non-recourse arrangement because more risk is transferred.

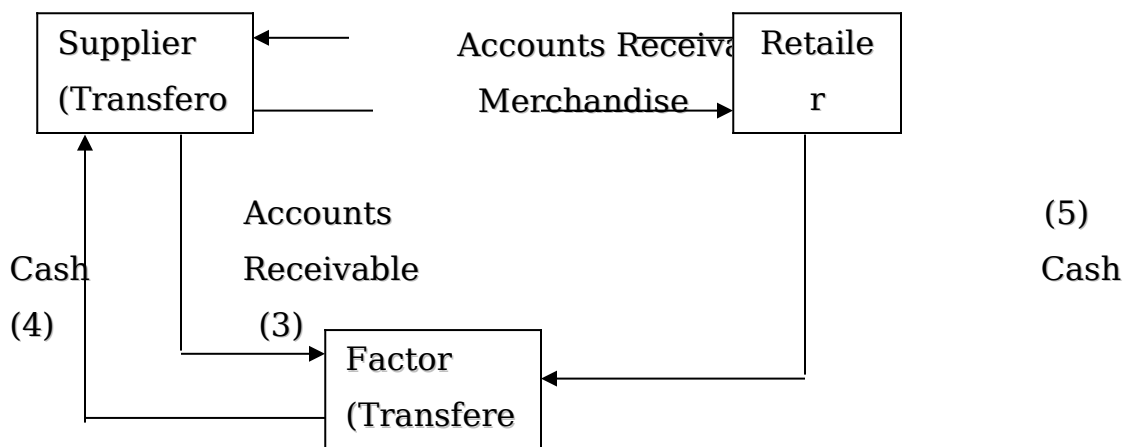
Agreements are made on either a notification basis (customers are directed to remit to the new party holding the receivables) or a non-notification basis (customers continue to remit to the original seller)

11.5.1 Factoring Accounts Receivable

Factoring refers to selling accounts receivable to another party. The enterprise selling the accounts receivable is called the transferor and the company buying the receivables is called transferee (factor).

Factoring transfers ownership of the receivables to the factor. In some instances, the factor performs credit verification, receivables servicing, and collection agency services, in effect taking over a company's accounts receivable and credit operations. Other factoring arrangements are less inclusive.

Factoring is common in the textile industry and in retailing. Suppliers to apparel retailers, department stores, and discount retailers prefer not to risk shipping merchandise without assurance that a factor will purchase the resulting receivables. The diagram below depicts the relationship among the parties.



The factor plays a key role in the continuance of the business relationship between supplier and retailer. The factor charges a fee in return for accepting the risk of default by retailers. If that risk increases, the factor will increase the fee, reduce the amount of receivables purchased, or suspend credit to the supplier.

When accounts receivable are factored (sold), the factoring arrangement can be with recourse or without recourse. If receivables are factored on a with recourse basis, the seller guarantees payment

to the factor in the event the debtor does not make payment. When a factor buys receivables without recourse, the factor assumes the risk of collectibles and absorbs any credit losses. Receivables that are factored with recourse should be accounted for as a sale, recognizing any gain or loss, if all three of the following conditions are met: (a) transfer surrenders control of the future economic benefits of the receivables, (b) transferors obligation under the recourse provisions can be reasonably estimated, and (c) transferee cannot require the transferor to repurchase the receivables. If these conditions are not met, the transfer is accounted for as a borrowing.

Factoring without recourse

A non-recourse factoring arrangement generally constitutes an ordinary sale of receivables because the factor has no recourse against the transferor for uncollectibles accounts. Control over the receivables generally passes to the factor. The factor typically assumes legal title to the receivables, the cost of uncollectibles accounts, and collection responsibilities. However, any adjustments or defects in the receivables (sales discounts, returns, and allowances) are borne by the seller (transfer) because these represent preexisting conditions.

The receivables are removed from the transferor's books, cash is debited, and a financing fee is recognized immediately as a financing expense or loss on sale. The factor may hold back an amount to cover probable sales adjustments. This amount is recorded as a receivable on the seller's books.

Example: Largo Company factors without recourse Br. 200,000 of accounts receivable with a finance company on a notification basis. The factor charges a 12 percent financing fee and retains an amount equal to 10 percent of the accounts receivable for sales adjustments.

Largo does not record bad debt expense on these receivables because, in non-recourse transfers, the finance company bears the cost of uncollectibles accounts. The entry to record the transfer is:

<u>Largo Company Books</u>	<u>Finance</u>
<u>Company Books</u>	
Cash (Br. 200,000 - ((0.12 + 0.1) Br. 20,000) --- 156,000	
Receivable from Factor (0.1 x Br. 200,000) ----- 20,000	Accounts
receivable --200,000	
Loss on sale of receivable (0.12 x Br. 200,000) ---24,000	payable
to Largo -----20,000	
Accounts receivable -----200,000	Finance
revenue -----24,000	
	Cash
-----156,000	

Largo company's loss equals the finance fee. This amount is also the book value of the receivables factors less the assets received from the finance company (Br. 200,000 - Br. 156,000 - Br. 20,000).

As customer sales adjustments occur, Largo records these deductions in the proper contra sales accounts and credits the receivables from factor. After all adjustments are recorded, any excess in the receivable is remitted to largo. If adjustments exceed the amount with held by the factor (Br. 20,000 in this case), either the finance company or the seller absorbs this amount as a loss or the two parties agree to allocate it in some other manner.

The remaining entries are based on the following additional information concerning the factored receivables:

- Br. 2000 of estimated and actual bad debts
- Br. 4000 of cash discounts
- Br. 12,000 of sales returns and allowances

Therefore, customers remitted Br. 182,000 (Br. 200,000 – Br. 2000 – Br. 4000 – Br. 12,000) to the finance company. The finance company records customer collections, reduces the payable to largo by the amount of actual sales adjustment (Br. 16,000), records bad debts, and settles with Largo.

<u>Largo Company's book</u>	<u>Finance Company's</u>
<u>book</u>	
Sales returns and allowance -----12,000	Bad debt Expense ----
2000	
Sales discount -----4000	Allowance for doubtful
account ----2000	
Receivable from factor -----16,000	
	Allowances for
doubtful accounts ---2000	
Cash (Br. 20,000 – Br. 4000 – Br. 12,000) --4000	Accounts
receivable -----2000	
Receivable from factor -----4000	Payable to Largo -----
16,000	
	Cash -----
182,000	
	Accounts
receivable -----182,000	
	Payable to Largo
-----4000	
	Cash
-----4000	

Factoring with recourse

When receivables are factored or otherwise transferred with recourse, the transferor bears the risk and cost of bad debts. The finance company has recourse against the transferor in the event of default by the original customer. Whether a sale or a loan should be recorded by the transferor is less clear than in non-recourse arrangements due to

the continuing involvement of the transferor with the transferred receivables.

A transfer of receivables or other financial assets is accounted for as a sale only if the transferor surrenders control over the assets transferred, and only to the extent that consideration other than a beneficial interest in the receivables is received. A beneficial interest is a right to receive cash flows from the receivables if the transfer retains a beneficial interest, the transferee may be unable to sell the assets, implying that control has not been completely relinquished by the transferor.

The transferor has surrendered control if, and only if, each of the following three conditions of SFAS No. 125, "Accounting for Transfers and servicing of financial Assets and Extinguishments of liabilities" are met:

1. The transferred assets have been isolated from the transferor put beyond the reach of the transferor and its creditors.
2. The transferor has the right to pledge or exchange the assets, free of conditions that constrain it from taking advantage of that right.
3. The transferor does not maintain effective control over the transferred assets through an agreement that (a) both entitles and obligates the transferor to repurchase the assets, or (b) entitles the transferor to repurchase assets that are not readily obtainable.

The recourse obligation by itself does not prevent the recording as a sale. Nor does an option held by the transferor to repurchase the receivables necessarily require recording the transfer as a loan.

For the first condition to be met, neither the transferor nor the creditors of the transferor (eg. in the event of the transferor's

bankruptcy) can retain a claim to the transferred receivables. Further, the transferor can't retain the right to revoke the transfer.

The second condition operationalizes the SFAC No. 6 definition of an asset in the context of factored receivables. If the transferee can sell or pledge the receivables without interference from the transferor or other parties, then the transferee has control over the future cash flows underlying the receivables, as a result of a past transaction.

The third condition pertains to a requirement that the transferor repurchase the assets or to an option to repurchase the receivables (a "call" option). If the transferor must repurchase the assets (common in repurchase agreements), control has not passed to the transferee.

In the case of an option, the transferor may wish to require interest-bearing receivables, for example, when interest rate changes would be favorable to the holder of the receivables. Although an option to repurchase the receivables may, at first, seem to imply that control has not passed to the transferee, the option does not entitle the transferor to receive interest or other benefits from the transferred receivables. The transferor does not have custody of the assets, does not control the disposition of the asset, and cannot access the asset unless the option is exercised.

However, the transferee must be in a position to fulfill the option, if it is exercised. The transferred assets, or similar assets, therefore must be readily obtainable. If assets were not readily obtainable, then the transferee would be constrained by the call option, would not be able to sell the assets, and would not effectively control the assets. Thus an agreement allowing the transferor to repurchase such assets would effectively maintain control with the transferor.

Transfer Accounts for as a sale

If the transfer of receivables meets the above three conditions, the transferor records the transfer as a sale of receivables. The transferor derecognizes the assets sold (removes the asset from the balance sheet) and recognizes any recourse liability. A gain or loss is also recognized by the transferor.

Proceeds from transfer = consideration received - Recourse liability

Gain or loss on transfer = Proceeds from transfer - Book value of receivables.

If the proceeds exceed the book value, a gain results, and vice-versa. The transferee recognizes all assets received at fair value.

Transfer Accounts for as a loan

If the transfer does not meet all three conditions, the transfer is accounted for as a secured borrowing. In this case, the transferor maintains the receivables on its books, records a liability, and recognizes interest over the loan term. The lender (transferee) maintains a security interest in the receivables (the receivables are used as collateral).

If the transferee is not permitted to sell or pledge the collateralized receivables unless the transferor defaults, the transferor continues to carry the assets on its books as previously classified. However, if the transferee is permitted to sell or pledge the assets, the transferor must reclassify the receivables and report them separately from other receivables.

Example: Largo Company factors with recourse Br. 200,000 of accounts receivable with a finance company on a notification basis. Accounting by Largo for both a sale and loan are illustrated. The finance company's entries are similar to the previous non-recourse

example. Assume the finance company charges 6 percent (less than in the recourse example), and Largo estimates its recourse liability for bad debts to be Br. 3000 (bad debts have not yet been recorded).

Largo company	
Recorded as a sale	Recorded as a loan
Cash -----188,000	Cash -----
188,000	
Loss on sale of receivables ---15,000*	Discount on payable
to factor12,000	
Accounts receivable -----200,000	Payable to
factor ----200,000	
Recourse liability -----3,000	

$$* 0.66 (\text{Br. } 200,000) + \text{Br. } 3000 = \text{Br. } 15,000$$

In the sales example, the proceeds to Largo equal Br. 185,000 (Br. 188,000 - Br. 3000), the difference between cash consideration received and the recourse liability. The loss is the difference between the proceeds and book value of the receivables and includes the estimated bad debts. The recourse liability is classified as current or non-current depending on the expected date of payment for defaulted accounts.

In the loan example, the discount account represents interest (the factor's fee) over the term of the loan. Interest expense is recognized on the balance of the payable to factor, which declines as customers make payments.

The remaining entries record payment of the recourse liability for default accounts in the sale example. In the loan example the payable to factor is extinguished as customers pay on account. Also shown are the recognition of bad debts and interest expense.

Largo company

Recorded as a sale	Recorded as a loan
Recourse liability -----3000	Bad debt Expense -----3000
Cash -----3000	Allowance for doubtful accounts 3000
accounts --3000	Allowance for doubtful accounts
receivable -----3000	Accounts Payable to factor
-----200,000	Accounts receivable -----197,000
-----3000	Cash -----12,000
-----12,000	Interest Expense
payable to factor 12,000	Discount on

The previous example assumed no sales returns and allowances or cash discounts. As in non-recourse factoring, sales adjustments reduce the cash obtained by the transferor from financing the receivables. The factor may hold back a part of the proceeds to protect against such adjustments.

Example: Assume the basic information in the Largo recourse example above and (1) the factor holds back. Br. 10,000 for returns and allowance and actual returns and allowance amount to Br. 6000. The entries for both sale and loan treatments are:

Largo company

Recorded as a sale

Cash -----178,000
178,000

Receivable from factor -----10,000
-----10,000

Loss on sale of receivable ---15,000
factor ---12,000

Accounts receivable -----200,000
-----200,000

Recourse liability -----3000

Sales returns & allowance ----6000
3000

Receivable from factor -----6000
doubtful accounts --3000

Recourse obligation -----3000
accounts ---3000

Cash -----1000+
-----3000

Receivable from factor -----4000

allowance --6000

receivable -----6000
+ Excess of hold-back over
-----200,000
actual sales returns & allowance Br. 4000
-----1000
(1000 - 6000)
Cash owed factor under
receivable ----191,000

Recorded as a loan

Cash -----

Receivable from factor

Discount on payable to

Payable to factor

Bad debt expense -----

Allowance for

Allowance for doubtful

Accounts receivable

Sales returns and

Accounts

Payable to factor

Cash

Accounts

Recourse obligation -----3000	Receivable form factor
---10,000	
Net cash to cargo -----Br. 1,000	Interest Expense
-----12,000	
	Discount on
payable	
	factor
-----12,000	

11.5.2 Assignment of Accounts Receivable

Assignment entails the use of receivables as collateral for a loan. An assignment of accounts receivable requires the assignor to assign the rights to specific receivables. Frequently, the assignor and the finance company (assignee) enter into a long-term agreement whereby the assignor receives cash from the finance company as sales are made. The accounts are assigned with recourse; the assignee has the right to seek payment from the specific receivables.

The assignor usually retains title to the receivables, continues to receive payments from customer (non notification basis), bears collection costs and the risk of bad debts, and agrees to use any cash collected from customers to pay the loan. A formal promissory note often allows the assignee (lender) to seek payment directly from the receivables if the loan is not paid when due.

The loan proceeds are typically less than the face value of the receivables assigned in order to compensate for sales adjustments and to give the assignee a margin of protection. The assignee charges a service fee and interest on the unpaid balance each month.

The receivables are reclassified as accounts receivable assigned, a separate category within accounts receivable used to disclose their status as collateral. The subsidiary accounts are also reclassified to

indicate their use as collateral, for internal accounting purposes. The loan balance is reported among the assignor's other liabilities.

Example: Assume that on November 30, 1992, Frank corporation assigns Br. 80,000 of its accounts receivable to a finance company on a non notification basis. Frank agrees to remit customer collections as payment to the loan. Loan proceeds are 85 percent of the receivables less a Br. 1,500 flat-fee finance charge. In addition, the finance company charges 12 percent interest on the unpaid loan balance, payable at the end of each month.

Accounts receivable assigned is a current asset listed under accounts receivable in the balance sheet. All entries are for Frank.

To record receipt of loan proceeds:

Cash ((0.85 x Br. 80,000) - Br. 1500)	-----66,500
Finance expense	-----1,500
Notes payable (Br. 80,000 x 0.85)	-----68,000

To classify accounts receivables as assigned:

Accounts receivable assigned	-----80,000
Accounts receivable	-----80,000

By the end of December, assume that Frank has collected Br. 46,000 cash on Br. 50,000 of the assigned accounts less Br. 3000 sales returns and Br. 1,000 sales discounts, and remits the proceeds to the finance company.

To record sales adjustments:

Cash (Br. 50,000 - Br. 3000 - Br. 1,000)	-----46,000
Sales discounts	-----1000
Sales returns and allowances	-----3000
Accounts receivable assigned	-----
50,000	

To remit collections to finance company:

Notes payable -----	45,320
Interest Expense (Br. 68,00 x 0.12 x 1/12) -----	680
Cash -----	46,000

Assigned accounts receivable are part of the total balance in accounts receivable. If the assigned amounts are material, they should be reported as a separate subtotal within accounts receivable.

Assume now that in January 1993, Br. 2000 of the accounts are written off as uncollectibles (the original Br. 8000 of receivables is included in the normal bad debt estimation process). Also, Br. 25,000 is collected on account. The remaining entries, follow, assuming that the loan is paid in full at the end of January

To record collection and write-off in January:

Cash -----	25,000
Allowance for doubtful accounts -----	2000
Accounts receivable assigned -----	27,000

January 31,1992- payment of remaining loan balance:

Notes payable (Br. 68,000 - Br. 45,320) -----	22,680
Interest Expense (Br. 22,680 x 0.12 x 1/12) -----	227
Cash -----	22,907

To record reclassification of remaining accounts:

Accounts receivable (Br. 80,000 - Br. 50,000 - Br. 27,000) -----	3000
Accounts receivable assigned -----	3000

Check your progress - 5

1. What does assignment of accounts receivable mean?

_____.

11.5.3 Pledging of Accounts Receivable

Pledging of accounts receivable is a less formal way of using receivables as collateral for loans. Typically, the receivables are transferred as collateral to the lender, escrow agent, or trustee. Proceeds from receivables must be used to pay the loan, but accounts receivable are not reclassified.

The original holder of the accounts receivables in pledging is called the pledge and the company providing the cash is called the pledgee. If the pledge (borrower) defaults on the loan, the pledge (creditor) has the right to use the receivables for payment.

The accounting for the receivables or the loan is not affected by pledging. When the loan is extinguished, the pledge is voided.

11.6 SUMMARY

Receivables are defined as claims held against others for money, goods, or services. Receivables may generally be classified as trade or non-trade. Trade receivables (accounts receivable) are the most significant receivables an enterprise possesses. They result from the credit sale of goods and services to customers in the normal operations of the business. Non-trade receivables arise from variety of transactions and can be written promises either to pay or to deliver. They are generally classified and reported as separate items in the balance sheet when they are material in amount.

The proper amount to record for a receivable is dependent upon the face value of the receivable, the probability of future collection, and the length of time the receivable will be outstanding.

In most receivable transaction, the amount to be recognized is the exchange price (amount due from the debtor) between two parties to

a sales transaction. Two elements that must be considered in measuring receivables are the availability of discounts and the length of time between sale and payment due date (the interest factor).

Two types of discount that must be considered in determining the value of receivables are trade discounts and cash discounts. Trade discounts represent reductions from the list or catalog prices of merchandise. They are often used to avoid frequent changes in catalogs or to quote different prices for different quantities purchased. Cash discounts (also called sales discounts) are offered as an inducement for prompt payment.

It is highly unlikely that a company that extends credit to its customers will be successful in collecting all of its receivables. Thus, some method must be adopted to account for receivables that ultimately prove to be uncollectibles. The two methods currently used are the direct write-off method and the allowance method. Under the direct-write-off the receivable account is reduced and an expense is recorded when a specific account is determined to be uncollectibles. The direct-write-off method is theoretically deficient because it usually does not match costs and revenues of the period, nor does it result in receivable being stated at estimated realizable value on the balance sheet.

Use of the allowance method requires a year-end estimate of expected uncollectibles accounts based upon credit sales or outstanding receivables. The estimate is recorded by debiting an expense and crediting an allowance account in the period in which the sale is recorded. Then in a subsequent period when an account is deemed to be uncollectibles, an entry is made debiting allowance account and crediting accounts receivable.

Companies wishing to avoid the 30 to 60 day collection period for accounts receivables can generate cash immediately by either assigning, or factoring, their accounts receivable. Assignment is a borrowing-type arrangement in which assigned accounts receivable are pledged as security for the loan received. Factoring of accounts receivable is an outright sale of the receivables to a finance company or bank.

The assignment of accounts receivable can be a general assignment or a specific assignment. In a general assignment, all accounts receivable serve as collateral for the note. Thus, new receivables can be substituted for the ones collected. In a specific assignment, an agreement is reached between the borrower and lender concerning who is to receive the collection, the finance charges, the specific accounts that serve as security, and notification or non-notification of debtors. The accounts assigned in a specific assignment should be transferred to a special ledger control account, and assignment should be clearly noted in the subsidiary ledger.

11.7 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. i. Cash discounts are offered by companies
 - to increase sales
 - to encourage early payment by the customer
 - to increase the likelihood of collection
- ii. A contra account to accounts receivable
2. Allowance method and Direct-charge of method
3. Direct charge-off method is used when
 - it is impossible to estimate with reasonable accuracy, the uncollectibles at the end of the period.

- An enterprise sells most of its goods and services on cash, the amount of its expense from uncollectibles accounts is usually small in relation to revenue.
4. Factors to be considered in the valuation of receivables are
- the probability that a receivable actually will be collected.
 - the length of time until collection.
5. Assignment of accounts receivable refers to the use of accounts receivable to as collateral for loan.

11.8 MODEL EXAMINATION QUESTIONS

I. True / False

_____ 1. The direct write-off method used in recording uncollectibles accounts receivable allows the Expense associated with bad debts always to be recorded in the accounting period in which the sale was made.

_____ 2. Because the collectibility of receivables is considered a loss contingency, the allowance method for recording bad debts is appropriate only institutions where it is probable that an asset has been impaired and that the amount of the loss can be reasonably estimated.

_____ 3. Factoring is the term used to describe the pledging of receivables as collateral for a loan.

_____ 4. If receivables are sold with recourse, the seller guarantees payment to the purchaser in the event the debtor does not pay.

_____ 5. The essence of a transfer of receivables in a borrowing transaction is that the transferor retains the same risks of collectibility on the receivables offer the transaction that it had before the transaction.

II. Multiple Choice

_____ 1. The advantage of relating a company's bad debt expense to its accounts receivable is that this approach

- a) gives a reasonably correct measure of receivables in the balance sheet
- b) related bad debt expense to the period of sale
- c) is the only generally accepted method of valuing accounts receivable
- d) makes estimates of uncollectibles accounts unnecessary

_____ 2. Which of the following statements untrue regarding uncollectibles accounts receivables?

- a) The direct write-off method records the bad debt in the year that it is determined that a specific receivable cannot be collected
- b) The allowance method is based on the assumption that the percentage of receivables that will not be collected can be predicted from past experiences, present market conditions, and an analysis of outstanding balances.
- c) The direct write-off method will provide for a proper matching of costs with revenues of the period when the matching monthly accounts receivable balance is consistent throughout the year.
- d) An uncollectibles account receivable is a loss of revenue that requires through proper entry in the account a decrease in the asset account receivable and a related decrease in income and stockholder's equity.

_____ 3. Alpha Corporation uses the allowance method of accounting for uncollectibles accounts. During 1993 alpha had charges to Bad Debts Expense of \$ 20,000 and wrote off as uncollectibles accounts receivables totaling Br. 16,000. These transactions decreased working capital by:

- a) Br. 20,000

- b) Br. 16,000
- c) Br. 4,000
- d) Br. 0.

_____ 4. In which of the following accounts receivable assignment arrangements do all receivables serve as collateral for the promissory note given by the assignor.

	General <u>Assignment</u>	Specific <u>Assignment</u>
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

_____ 5. Of the following conditions which is the only one that is not required if the transfer of receivables with recourse is to be accounted for as a sale?

- A. The transferor is obligated to make a genuine effort to identify those receivables that are uncollectibles
- B. The transferor surrenders control of the future economic benefits fo the receivables
- C. The transferee cannot require the transferor to repurchase the receivables
- D. The transferor's obligation under the recourse provisions can be reasonably estimated

III. Exercises

1. Wool Corporation began operations in year 1 and had accounts receivable of Br. 300,000 on December 31, year 1. In determining the valuation of receivables on December 31, year 1, management wished to recognize the following:

Estimated doubtful accounts -----

Br. 6,240

Estimated collection costs -----

Br. 1,800

Estimated price adjustments & other allowances

On outstanding receivables (no returns of merchandise are anticipated) Br. 3,000

Estimated cash (fuels) discounts -----

Br. 3,600

A) Prepare an adjusting entry for Wool Corporation on December 31, year 1, to recognize management's estimate of the net realizable value of accounts receivable. No accounts were written off in year 1.

B) Show how accounts receivable are reported in Wool Corporation's balance sheet on December 31, year 1.

2. Certain information relative to the operations of Murphy Company for year 10 follow:

Trade accounts receivable, Jan. 1 -----

Br. 16,000

Trade accounts receivable collected during year

-----Br. 52,000

Cash sales -----

10,000

Inventories, Jan. 1 -----

24,000

Inventories, Dec. 31 -----

22,000

Purchases -----

40,000

Gross profit on sales -----

18,000

Compute the amount of Murphy Company's trade accounts receivable on December 31, year 10

3. In the second half of year 3, Jakarta Imports Company required additional cash for its operations and used trade accounts receivable to raise cash as follows:

(1) On July 1, Jakarta imports assigned br. 300,000 of trade accounts receivable to Finance Company. Jakarta import received an advance from finance of 85% of the assigned receivables, less a fee of 3% on the advance. Prior to December 31, year 3, Jakarta imports collected br. 490,000 on the assigned receivables, and remitted br. 185,000 to finance, br. 13,500 of which represented interest on the advance (loan payable).

(2) On Nov. 10, Jakarta imports sold br. 310,000 of trade accounts receivable for br. 280,000. The receivables had a carrying amount of br. 290,000 and were sold on a non-recourse basis.

(3) On Dec. 31, Jakarta imports obtained a loan of br. 125,000 from Rosen Bank by pledging br. 180,000 of trade accounts receivable.

4. At January 1, 1992, the credit balance in the allowance for doubtful accounts of the Abugida Company was Br. 200,000. the provision (expense) for doubtful accounts is based on a percentage of net credit sales. Total sales revenue for 1992 amounted to br. 75 mullions, of which one third was on credit. Based on the latest available facts, the 1992 provision needed for doubtful accounts is estimated to be three-fourths of 1 percent of net credit sales. During 1992, uncollectibles receivables amounting to Br. 220,000 were written-off.

Required: Give all 1992 of entries related to doubtful accounts

5. A company sold accounts receivables of Br. 10, 000 (allowance for doubtful accounts Br. 300) for Br. 9,000, with recourse. Estimated obligations due to the with-recourse provision amounted to Br. 700

Required: Give the required entry, assuming a sale is recorded.

11.9 GLOSSARY

1. Accounts receivable: A claim against a customer for sales made on credit.
2. Aging of accounts receivable: The process of listing each accounts receivable customer according to the due date of the account.
3. Allowance method: A method of accounting for uncollectibles accounts whereby estimated uncollectibles accounts are expensed in the period in which the related sales take place.
4. Assignment: Use of accounts receivable as a collateral for loan by using promissory note.
5. Direct charge-off method: A method of accounting for uncollectibles accounts by directly debiting expenses when bad debts are discovered
6. Factoring: The selling or transferring of accounts receivable.

