CHAPTER 9

Receivables

Accounting 27e

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Classification of Receivables

- The term **receivables** includes all money claims against other entities, including people, companies, and other organizations.
- The receivables that result from sales on account are normally accounts receivable or notes receivable.
- Notes and accounts receivable that result from sales transactions are sometimes called trade receivables.

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Accounts Receivables

- The most common transaction creating a receivable is selling merchandise or services on account (on credit).
- The receivable is recorded as a debit to Accounts Receivable.
- Such **accounts receivable** are normally collected within a short period, such as 30 or 60 days.
- They are classified on the balance sheet as a current asset.

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Notes Receivables

- **Notes receivable** are amounts that customers owe for which a formal, written instrument of credit has been issued.
- If notes receivable are expected to be collected within a year, they are classified on the balance sheet as a current asset.
- Notes are often used for credit periods of more than 60 days.
- Notes may also be used to settle a customer's accounts receivable.

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Other Receivables

- Other receivables include:
  - Interest receivable
  - Taxes receivable
  - Receivables from officers or employees
- Other receivables are normally reported separately on the balance sheet.
  - If they are expected to be collected within one year, they are classified as current assets.
  - If collection is expected beyond one year, these receivables are classified as noncurrent assets and reported under the caption Investments.

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Uncollectible Receivables
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- A major issue of selling merchandise or services on account (on credit) is that some customers will not pay their accounts. That is, some accounts receivable will be uncollectible.
- Companies may shift the risk of uncollectible receivables to other companies by not accepting sales on account.
- Companies may also sell their receivables. Selling receivables is called factoring the receivables.
- The operating expense recorded from uncollectible receivables is called **bad debt expense**, uncollectible accounts expense, or doubtful accounts expense.

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Uncollectible Receivables
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- The two methods of accounting for uncollectible receivables are as follows:
  - The **direct write-off method** records bad debt expense only when an account is determined to be worthless.
    - The direct write-off method is often used by small companies and companies with few receivables.
  - The **allowance method** records bad debt expense by estimating uncollectible accounts at the end of the accounting period.
    - Generally accepted accounting principles (GAAP) require companies with a large amount of receivables to use the allowance method.

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Direct Write-Off Method for Uncollectible Accounts

- An account receivable that has been written off may be collected later.
- In such cases, the account is reinstated by an entry that reverses the write-off entry.
- The cash received in payment is then recorded as a receipt on account.

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Write-Offs to the Allowance Account
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- When a customer's account is identified as uncollectible, it is written off against the allowance account.
- This requires the company to remove the specific accounts receivable and an equal amount from the allowance account.

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Write-Offs to the Allowance Account
(slide 2 of 2)

- Because Allowance for Doubtful Accounts is based on an estimate, it will normally have a balance at the end of a period. The total write-offs to the allowance account during the period will rarely equal the balance of the account at the beginning of the period.
  - The allowance account will have a credit balance at the end of the period if the write-offs during the period are less than the beginning balance.
  - The allowance account will have a debit balance at the end of the period if the write-offs during the period exceed the beginning balance.
- An account receivable that has been written off against the allowance account may be collected later.

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Estimating Uncollectibles

- The allowance method requires an estimate of uncollectible accounts at the end of the period.
- This estimate is normally based on past experience, industry averages, and forecasts of the future.
- The two methods used to estimate uncollectible accounts are as follows:
  - Percent of sales method
  - Analysis of receivables method

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Percent of Sales Method

- Since accounts receivable are created by credit sales, uncollectible accounts can be estimated as a percent of credit sales.

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Analysis of Receivables Method
(slide 1 of 3)

- The analysis of receivables method is based on the assumption that the longer an account receivable is outstanding, the less likely it is that it will be collected.
- The steps on the next slide are then summarized in an aging schedule. This overall process is called **aging the receivables**.

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Analysis of Receivables Method
(slide 2 of 3)

- The analysis of receivables method is applied as follows:
  - Step 1: The due date of each account receivable is determined.
  - Step 2: The number of days each account is past due is determined. This is the number of days between the due date of the account and the date of the analysis.
  - Step 3: Each account is placed in an aged class according to its days past due (e.g., 1–30 days past due, 31–60 days past due, 61–90 days past due, and so on)
  - Step 4: The totals for each aged class are determined.
  - Step 5: The total for each aged class is multiplied by an estimated percentage of uncollectible accounts for that class.
  - Step 6: The estimated total of uncollectible accounts is determined as the sum of the uncollectible accounts for each aged class.

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Analysis of Receivables Method
(slide 3 of 3)

- The sum of the estimated uncollectible accounts is the estimated uncollectible accounts on December 31, 20Y8.
- This is the desired adjusted balance for Allowance for Doubtful Accounts.
- Comparing the sum of the estimated uncollectible accounts in the aging schedule with the unadjusted balance of the allowance account determines the amount of the adjustment for Bad Debt Expense.

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Notes Receivable

- A note receivable, or promissory note, is a written document containing a promise to pay the face amount, usually with interest, on demand or at a date in the future.
- By signing a note, the debtor recognizes the debt and agrees to pay it according to its terms. Thus, a note is a stronger legal claim over an account receivable.

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Characteristics of Notes Receivable
(slide 1 of 2)

- Characteristics of a promissory note are as follows:
  1. The *maker* is the party making the promise to pay.
  2. The *payee* is the party to whom the note is payable.
  3. The *face amount* is the amount for which the note is written on its face.
  4. The *issuance date* is the date a note is issued.
  5. The *due date* or *maturity date* is the date the note is to be paid.
  6. The *term* of a note is the amount of time between the issuance and due dates.
  7. The *interest rate* is the rate of interest that must be paid on the face amount for the term of the note.

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Characteristics of Notes Receivable
(slide 2 of 2)

- The interest on the note is computed as follows:

$$\text{Interest} = \text{Face Amount} \times \text{Interest Rate} \times (\text{Term} \div 360 \text{ days})$$

- The **maturity value** is the amount that must be paid at the due date of the note, which is the sum of the face amount and the interest.

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Accounting for Notes Receivable

- A promissory note may be received by a company from a customer to replace an account receivable. In such cases, the promissory note is recorded as a note receivable.
- If the maker of the note fails to pay the note on the due date, it is considered a **dishonored note receivable**.
- The face amount of the note plus any interest due are then transferred back to the customer's account receivable account.
- A company receiving a note should record an adjusting entry for any accrued interest at the end of the period.

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Reporting Receivables on the Balance Sheet

- All receivables that are expected to be realized in cash within a year are reported in the Current assets section of the balance sheet.

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Financial Analysis and Interpretation: Accounts Receivable Turnover

- The **accounts receivable turnover** measures how frequently during the year the accounts receivable are being converted to cash.
- The accounts receivable turnover is computed as follows:

$$\text{Accounts Receivable Turnover} = \frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

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Financial Analysis and Interpretation: Days' Sales in Receivables

- The **days' sales in receivables** is an estimate of the length of time the accounts receivable have been outstanding.
- The days' sales in receivables is computed as follows:

$$\text{Days' Sales in Receivables} = \frac{\text{Average Accounts Receivable}}{\text{Average Daily Sales}}$$

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