CHAPTER 9
ACCOUNTING FOR RECEIVABLES

Chapter Outline

Notes

I. Accounts Receivable—Amounts due from customers for credit sales. They occur when a customer uses credit cards issued by third parties and when a company gives credit directly to customers.

A. Recognizing Accounts Receivable:

B. Valuing Accounts Receivable
Accounts of customers who do not pay are uncollectible accounts, commonly called *bad debts*. Two methods are used to account for uncollectible accounts:

1. Direct Write-off Method
Records the loss from an uncollectible account receivable when it is determined to be uncollectible.
    a. To write off uncollectible and recognize loss: debit Bad Debt Expense, credit Accounts Receivable.
    b. If a written off account is later collected, this results in a reversal of the write-off (see above) and a normal collection of account entry.
    c. This method violates the matching principle since it frequently results in expense being charged in a period after that of the credit sale.
    d. Materiality constraint states that an amount can be ignored if its effect on the financial statements is unimportant to users' decisions. This constraint permits use of direct write-off when bad debts expenses are very small in relation to other financial statement items such as sales and net income.

2. Allowance Method
Matches the *estimated* loss from uncollectibles against the sales they helped produce.
    a. At the end of each accounting period, bad debts expense is *estimated* and recorded in an adjusting entry.
    b. To record estimate of bad debt expense, Debit Bad Debt Expense, credit a contra-asset account called Allowance for Doubtful Accounts.
    c. Advantages of method:
        i. Satisfies the matching principle because expense is charged in the period of the corresponding sale.
        ii. Reports accounts receivable on balance sheet at the estimated amount of cash to be collected.
    d. To write-off an uncollectible: debit Allowance for

Doubtful Accounts, credit Accounts Receivable.

e. Writing off an uncollectible does not change the estimated amount of cash to be collected (realizable value of accounts receivable).

f. If a written off account is later recovered (collected) , this results of a reversal of the write off (see d above) and a normal collection of account entry.

D. Estimating Bad Debts Expense—two methods:

1. Percent of Sales Method (uses income statement relations to estimate)—bad debts expense is computed as a percentage of sales for the period.

a. Sales figure chosen as base is usually *credit* sales but it can be total or net sales if cash sales are small.

b. The estimate is used in the adjusting entry. Note that the resulting reported allowance account balance is rarely equal the reported expense because the allowance account was not likely to be zero prior to adjustment.

2. Accounts Receivable methods (uses balance sheet relations to estimate)—desired credit balance in Allowance for Doubtful Accounts is computed:

a. As a percentage of outstanding receivables (simplified approach) or

b. By aging accounts receivable.

a. The amount in the adjustment is calculated by determining the amount necessary to bring allowance account to a credit balance equivalent to the estimated uncollectibles.

II. **Notes Receivable—** *Promissory note* that is a written promise to pay a specified amount of money *(principal)* either on demand or on a definite future date. Most notes are interest bearing. Promissory notes are notes payable to the *maker* (person promising to pay) and notes receivable to the *payee* (person to be paid).

A. Computations for Notes

1. *Maturity date* is the date the note must be repaid.

2. Amount to be repaid is principal plus interest (*maturity value*).

3. The *period* of the note is the time from the note's date to its maturity date.

4. Formula for computing annual interest:

		Annual		Time of note		
Principal of	**x**	rate of	**x**	expressed	=	Interest
note		interest		in years		

B. Recognizing Notes Receivable—debit Notes Receivable for principal or face amount of note. Credit will vary; depends on reason note is received. Note that interest is not recorded until earned.

C. Valuing and Settling Notes

1. Recording an honored note—debit Cash for maturity value (face and interest), credit Note Receivable for face amount and credit Interest Revenue for the interest amount.
2. Recording a dishonored note—debit Accounts Receivable for maturity value, credit Note Receivable for face amount and credit Interest Revenue for the interest amount. If account receivable remains uncollected, it will be written-off.
3. Recording End-of-Period Interest Adjustment—record accrued interest by debiting Interest Receivable and crediting Interest Revenue.
4. Collection entry if some interest was accrued requires a debit to Cash for full amount received, credits to Interest Receivable (amount previously accrued), Interest Revenue (amount earned since accrual date) and Notes Receivable (face amount of note).

III. Disposing of Receivables—Companies can convert receivables to cash before they are due. Reasons for this include the need for cash or a desire to not be involved in collection activities.

A. Selling Receivables
   1. Buyer, called a *factor*, charges the seller a *factoring fee* and then collects the receivables as they come due.
   2. Entry: debit Cash (amount received), and Factoring Fee Expense (amount charged) and credit Accounts Receivable (amount sold).

B. Pledging Receivables
   1. Company borrows money by pledging its receivables as security.
   2. Borrower retains ownership of the receivables.
   3. If borrower defaults, the lender has right to be paid from receipts on accounts receivable when collected.
   4. The pledge should be disclosed in financial statement footnotes.
   5. The loan is recorded as a debit to Cash and a credit to Notes Payable.