CHAPTER 9
ACCOUNTING FOR RECEIVABLES

LEARNING OBJECTIVES

1. IDENTIFY THE DIFFERENT TYPES OF RECEIVABLES.

2. EXPLAIN HOW COMPANIES RECOGNIZE ACCOUNTS RECEIVABLE.

3. DISTINGUISH BETWEEN THE METHODS AND BASES COMPANIES USE TO VALUE ACCOUNTS RECEIVABLE.

4. DESCRIBE THE ENTRIES TO RECORD THE DISPOSITION OF ACCOUNTS RECEIVABLE.

5. COMPUTE THE MATURITY DATE OF AND INTEREST ON NOTES RECEIVABLE.

6. EXPLAIN HOW COMPANIES RECOGNIZE NOTES RECEIVABLE.

7. DESCRIBE HOW COMPANIES VALUE NOTES RECEIVABLE.

8. DESCRIBE THE ENTRIES TO RECORD THE DISPOSITION OF NOTES RECEIVABLE.

9. EXPLAIN THE STATEMENT PRESENTATION AND ANALYSIS OF RECEIVABLES.
CHAPTER REVIEW

Types of Receivables

1. (L.O. 1) **Receivables** are claims that are expected to be collected in cash. Receivables are usually classified as: (a) accounts receivable, (b) notes receivable, and (c) other receivables.

2. **Accounts receivable** are amounts customers owe on account. **Notes receivable** are a written promise (as evidenced by a formal instrument) for amounts to be received. And **other receivables** include nontrade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable.

Recognizing Accounts Receivable

3. (L.O. 2) When a business sells merchandise to a customer on credit, Accounts Receivable is debited and Sales Revenue is credited.

4. If a payment is received by a customer within the discount period, the following entry is made:

   Cash ................................................................. XXX
   Sales Discounts ................................................. XXX
   Accounts Receivable ...................................... XXX

Valuing Accounts Receivable

5. (L.O. 3) Companies record credit losses as debits to Bad Debt Expense (or Uncollectible Accounts Expense). Such losses are considered to be a normal and necessary risk of doing business. Two methods are used in accounting for uncollectible accounts: (a) the direct write-off method and (b) the allowance method.

Direct Write-off Method for Uncollectible Accounts

6. Under the direct write-off method, bad debt losses are not anticipated and no allowance account is used.
   a. No entries are made for bad debts until an account is determined to be uncollectible at which time the loss is charged to Bad Debt Expense.
   b. This method makes no attempt to match bad debt expense to sales revenue in the income statement or to show the cash realizable value of the accounts receivable in the balance sheet.
   c. This method is not acceptable for financial reporting purposes, unless bad debt losses are insignificant.

7. The **allowance method** is required when bad debts are material in amount. Its essential features are:
   a. Uncollectible accounts are estimated and the expense for the uncollectible accounts is matched against sales revenue in the same accounting period in which the sales occurred.
   b. **Estimated uncollectibles** are debited to Bad Debt Expense and credited to Allowance for Doubtful Accounts through an adjusting entry at the end of each period.
   c. **Actual uncollectibles** are debited to Allowance for Doubtful Accounts and credited to Accounts Receivable at the time a specific account is written off.

8. When there is a recovery of an account that has been written off as uncollectible, it is necessary to:
   a. reverse the entry made when the account was written off, and
   b. record the collection in the usual manner.

9. There are two bases that are used to determine the amount of expected uncollectibles. One is the percentage-of-sales basis, and the other is the percentage-of-receivables basis.
Percentage-of-Sales Basis

10. Under the **percentage-of-sales basis**, 
   a. Management establishes a percentage relationship between the amount of credit sales and expected losses from uncollectible accounts. 
   b. The expected bad debt losses are determined by applying the percentage to the sales base of the current period. 
   c. This basis better matches expenses with revenues.

Percentage-of-Receivables Basis

11. Under the **percentage-of-receivables basis**, 
   a. The balance in the allowance account is derived from an analysis of individual customer accounts. The analysis is often called *aging the accounts receivable*. 
   b. The amount of the adjusting entry is the difference between the required balance and the existing balance in the allowance account. 
   c. This basis produces the better estimate of **cash realizable value** of the accounts receivable.

Disposing Accounts Receivable

12. (L.O. 4) In order to accelerate the receipt of cash from receivables, owners frequently (1) sell to a factor such as a finance company or bank, or (2) make credit card sales. 

13. A factor buys receivables from businesses for a fee and then collects the payments directly from the customers. The entry for a sale to a factor is:

   Cash .......................................................... XXX 
   Service Charge Expense................................. XXX 
   Accounts Receivable .................................. XXX 

14. Credit cards are frequently used by retailers because the retailer does not have to be concerned with the customer’s credit history and the retailer can receive cash more quickly from the credit card issuer. However, the credit card issuer usually receives a fee of from 2–6% of the invoice price from the retailer.

Notes Receivable

15. (L.O. 5) A **promissory note** is a written promise to pay a specified amount of money on demand or at a definite time. The party making the promise is called the maker; the party to whom payment is made is called the payee.

16. When the life of a note is expressed in terms of months, the due date is found by counting the months from the date of issue. When the due date is stated in terms of days, it is necessary to count the days. In counting days, the date of issue is omitted but the due date is included.

17. The basic formula for computing interest on an interest bearing note is:

   \[
   \text{Interest} = \text{Face Value of Note} \times \text{Annual Interest Rate} \times \frac{\text{Time in Terms of One Year}}{1} 
   \]
Recognizing Notes Receivable

18. (L.O. 6) Entries for notes receivable are required when the note is received and at maturity. To illustrate, assume that on June 1, 2014, Raider Company receives a $2,000, 3-month, 12% note receivable from Paul Revere in settlement of an open account. The entry is:

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 1</td>
<td>Notes Receivable</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Valuing Notes Receivable

19. (L.O. 7) Like accounts receivable, short-term notes receivable are reported at their cash (net) realizable value and an Allowance for Doubtful Accounts is used.

Disposing of Notes Receivable

20. (L.O. 8) On September 1, the maturity date, Paul Revere honors the note by paying the face amount, $2,000 plus interest of $60 ($2,000 X 12% X 3/12). Assuming that interest has not been accrued, the entry is:

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sept. 1</td>
<td>Cash</td>
<td>2,060</td>
</tr>
<tr>
<td></td>
<td>Notes Receivable</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>Interest Revenue</td>
<td>60</td>
</tr>
</tbody>
</table>

Statement Presentation and Analysis

21. (L.O. 9) In the balance sheet, short-term receivables are reported within the current assets section below short-term investments. Both the gross amount of receivables and the allowance for doubtful accounts should be reported. In a multiple-step income statement, Bad Debt Expense and Service Charge Expense are reported as selling expenses in the operating expenses section.

22. The accounts receivable turnover is computed by dividing net credit sales (net sales less cash sales) by the average net accounts receivable during the year. The average collection period, a variant of the accounts receivable turnover, is computed by dividing the turnover ratio into 365 days. The average collection period should not greatly exceed the credit term period.
A. Types of Receivables.

1. Receivables refer to amounts due from individuals and companies that are expected to be collected in cash.

2. Receivables are classified as:
   a. **Accounts receivable** are amounts customers owe on account. Companies generally expect to collect these receivables within 30 to 60 days.
   b. **Notes receivable** are a written promise (as evidenced by a formal instrument) for amounts to be received. A note normally requires the collection of interest and extends for time periods of 60 to 90 days or longer.
   c. **Other receivables** include nontrade receivables such as interest receivable, loans to company officers, advances to employees, and income taxes refundable.

B. Recognizing Accounts Receivable.

1. Accounts receivable are recognized when merchandise is sold on account, as explained in Chapter 5.

2. Recognizing accounts receivable also occurs when a company sells merchandise and a customer uses the company’s own credit card.
   a. Credit card sales result in a debit to Accounts Receivable and a credit to Sales Revenue.
   b. If customers fail to pay within a specified period (usually 30 days), the seller adds interest. The interest is debited to Accounts Receivable and credited to Interest Revenue.
C. Valuing Accounts Receivable.

1. Valuing receivables involves reporting receivables at their cash (net) realizable value. Cash (net) realizable value is the net amount expected to be received in cash.

2. Uncollectible Accounts Receivable.
   
a. Credit losses are a normal and necessary risk of doing business on a credit basis. Credit losses may be recognized under the allowance method or by the direct write-off method.

   b. GAAP requires the allowance method for financial reporting purposes when bad debts are material in amount. Under this method:
      
      (1) Companies estimate uncollectible accounts receivable and match this estimate expense against revenues in the same accounting period in which they record the revenues.

      (2) Companies debit estimated uncollectibles to Bad Debt Expense and credit them to Allowance for Doubtful Accounts (a contra-asset account) through an adjusting entry at the end of each period.

      (3) When companies write off a specific account, they debit actual uncollectibles to Allowance for Doubtful Accounts and credit that amount to Accounts Receivable.

3. Occasionally, a company collects from a customer after it has written off the account as uncollectible. The company

   a. Reverses the entry made in writing off the account to reinstate the customer’s account.

   b. Journalizes the collection in the usual manner.
4. Two bases are used to determine the amount of the expected uncollectibles:

   a. Under the percentage-of-sales basis, management estimates what percentage of credit sales will be uncollectible. This percentage is based on past experience and anticipated credit policy, and is applied either to total credit sales or net credit sales of the current year.

      (1) This basis of estimating uncollectibles emphasizes the matching of expenses with revenues (income statement viewpoint).

      (2) When the company makes the adjusting entry, it disregards the existing balance in Allowance for Doubtful Accounts.

   b. Under the percentage-of-receivables basis, management estimates what percentage of receivables will result in losses from uncollectible accounts. The company prepares an aging schedule, in which it classifies customer balances by the length of time they have been unpaid.

      (1) This method normally results in the better approximation of cash realizable value (balance sheet viewpoint).

      (2) An aging schedule is used to determine the required balance in the allowance account at the balance sheet date.

      (3) The amount of the bad debt expense adjusting entry is the difference between the required balance and the existing balance in the allowance account.

   TEACHING TIP

   Emphasize the income statement point of view—the matching of bad debt expense with revenues in the same period.

   Emphasize an aging schedule is provided to arrive at the required balance for the allowance account. Emphasize the balance sheet point of view—the determination of the net realizable value of the receivables.
5. The direct write-off method may be used for financial reporting purposes only when bad debts are insignificant. Under this method:

a. Bad debt losses are not estimated and an allowance account is not used.

b. Bad debt losses are debited to Bad Debt Expense when they are determined to be uncollectible.

c. This method does not attempt to match bad debt expense with sales revenues or to show accounts receivable in the balance sheet at the amount the company actually expects to receive.

D. Disposing of Accounts Receivable.

1. In the normal course of events, companies collect accounts receivable in cash and remove receivables from the books.

2. Companies frequently sell their receivables to another company for cash, which shortens the cash-to-cash operating cycle.

3. A sale may be made to a factor which is a finance company or bank that buys receivables from businesses and then collects the payments directly from the customers.

4. A credit card sale occurs when a company accepts national credit cards, such as Visa, Mastercard, and American Express.

   a. A retailer’s acceptance of a national credit card is another form of selling (factoring) the receivable.

   b. The retailer generally considers sales from the use of national credit card sales as cash sales. The retailer must pay to the bank that issues the card a fee of 2 to 6% for processing the transactions.
ASSIGNMENT ACROSS THE ORGANIZATION

Assume you use a Visa card to purchase some new ties at Nordstrom. Visa acts as the clearing agent for the transaction and transfers funds from the bank that issued your Visa card to Nordstrom’s bank account.

If Nordstrom prepares a bank reconciliation monthly and some credit card sales have not been processed by the bank, how should Nordstrom treat these transactions on its reconciliation?

**Answer:** Nordstrom would treat the credit card receipts as deposits in transit. It has already recorded the receipts as cash. Its bank will increase Nordstrom’s cash account when it receives the receipts.

**E. Notes Receivable.**

1. A promissory note is a written promise to pay a specified amount of money on demand or at a definite time. Notes receivable give the payee a stronger legal claim to assets than accounts receivable. Promissory notes may be used:
   a. When individuals and companies lend or borrow money.
   b. When the amount of the transaction and the credit period exceed normal limits.
   c. In settlement of accounts receivable.

2. Determining the maturity date. When the life of a note is expressed in terms of months, you find the date when it matures by counting the months from the date of issue. When the due date is stated in terms of days, you need to count the exact number of days to determine the maturity date. In counting, omit the date the note is issued but include the due date.
3. Computing interest. The formula for computing interest is face value of note times annual interest rate times time in terms of one year. For a note stated in months, a fraction of the year is used; when a note is stated in days, time factor is the number of days in the note divided by 360.

4. Recognizing notes receivable occurs when the note is received. The company records the note receivable at its face value by debiting Notes Receivable and crediting Accounts Receivable.

5. Valuing short-term notes receivable involves reporting notes receivable at their cash (net) realizable value.

   a. The notes receivable allowance account is Allowance for Doubtful Accounts.

   b. The estimations involved in determining cash realizable value and in recording bad debt expense and the related allowance are similar.

6. Disposing of notes receivable involves the honoring (paying) or dishonoring (not paying) of the note at maturity.

   a. A note is honored when its maker pays it in full at its maturity date. If interest has been accrued prior to maturity, Interest Receivable is credited for the accrued interest at maturity.

   b. A dishonored (defaulted) note is a note that is not paid in full at maturity. The entry to record the dishonor of a note depends on whether the payee expects eventual collection. If the debtor is expected to pay, Accounts Receivable is debited for the face value of the note plus accrued interest. If there is no hope of collection, the payee would write off the face value of the note by debiting Allowance for Doubtful Accounts.
F. Statement Presentation and Analysis.

1. Companies should identify in the balance sheet or in the notes to the financial statements each of the major types of receivables.

2. Short-term receivables appear in the current assets section of the balance sheet. Companies report both the gross amount of receivables and the allowance for doubtful accounts.

3. In a multiple-step income statement, companies report bad debt expense and service charge expense as selling expenses in the operating expenses section. Interest revenue appears under “Other revenues and gains” in the nonoperating activities section.

4. Investors and managers evaluate accounts receivable for liquidity by computing the accounts receivable turnover and an average collection period.

   a. The accounts receivable turnover is computed by dividing net credit sales by the average net accounts receivable during the year. This ratio measures the number of times, on average, the company collects accounts receivable during the period.

   b. The average collection period is computed by dividing the accounts receivable turnover into 365 days. Companies frequently use the average collection period to assess the effectiveness of a company's credit and collection policies.
A Look at IFRS

The basic accounting and reporting issues related to recognition and measurement of receivables, such as the use of allowance accounts, how to record discounts, use of the allowance method to account for bad debts, and factoring, are essentially the same between IFRS and GAAP.

KEY POINTS

- IFRS requires that loans and receivables be accounted for at amortized cost, adjusted for allowances for doubtful accounts. IFRS sometimes refers to these allowances as provisions.
- Although IFRS implies that receivables with different characteristics should be reported separately, there is no standard that mandates this segregation.
- The FASB and IASB have worked to implement fair value measurement (the amount they currently could be sold for) for financial instruments. Both Boards have faced bitter opposition from various factions. As a consequence, the Boards have adopted a piecemeal approach. The first step is disclosure of fair value information in the notes. The second step is the fair value option, which permits, but does not require, companies to record some types of financial instruments at fair values in the financial statements.
- IFRS requires a two-tiered approach to test whether the value of loans and receivables are impaired. First, a company should look at specific loans and receivables to determine whether they are impaired. Then, the loans and receivables as a group should be evaluated for impairment. GAAP does not prescribe a similar two-tiered approach.
- IFRS and GAAP differ in the criteria used to determine how to record a factoring transaction. IFRS uses a combination approach focused on risks and rewards and loss of control. GAAP uses loss of control as the primary criterion. In addition, IFRS permits partial derecognition of receivables; GAAP does not.
LOOKING TO THE FUTURE

It appears likely that the question of recording fair values for financial instruments will continue to be an important issue to resolve as the Boards work toward convergence. Both the IASB and the FASB have indicated that they believe that financial statements would be more transparent and understandable if companies recorded and reported all financial instruments at fair value. That said, in IFRS 9, which was issued in 2009, the IASB created a split model, where some financial instruments are recorded at fair value, but other financial assets, such as loans and receivables, can be accounted for at amortized cost if certain criteria are met. Critics say that this can result in two companies with identical securities accounting for those securities in different ways. A proposal by the FASB would require that nearly all financial instruments, including loans and receivables, be accounted for at fair value. It has been suggested that IFRS 9 will likely be changed or replaced as the FASB and IASB continue to deliberate the best treatment for financial instruments. In fact, one past member of the IASB said that companies should ignore IFRS 9 and continue to report under the old standard. In his opinion, it was extremely likely that it would be changed before 2013, the mandatory adoption date of the standard.
20 MINUTE QUIZ

Circle the correct answer.

True/False

1. Receivables are classified as accounts, notes, or other.
   True    False

2. Financing charges added to a customer’s credit card balance with a retailer are recorded as a debit to Accounts Receivable and a credit to Interest Revenue.
   True    False

3. The allowance method for uncollectible accounts violates the expense recognition principle.
   True    False

4. An aging schedule shows a required balance in Allowance for Doubtful Accounts of $8,600. If there is a credit balance in the allowance account of $2,000 prior to adjustment, the adjustment amount is $6,600.
   True    False

5. Sale of receivables to a factor may result in a debit to Service Charge Expense at the time of sale.
   True    False

6. The maturity date of a 60-day note dated December 1 is January 31.
   True    False

7. The interest due at maturity of a two-month, 8%, $800 note is computed by multiplying $800X.08 X 2/12.
   True    False

8. The maturity value of a $5,000 note is $5,300. If $180 of the interest has been accrued prior to maturity, the entry to record the honoring of the note at maturity should include a credit to Interest Revenue for $120.
   True    False

9. The principal amount of a 9%, 3-year, note receivable is $300,000 and is dated January 1, 2014. The interest revenue to be recognized on December 31, 2014, is $9,000.
   True    False

10. Short-term receivables are reported in the balance sheet immediately below cash.
    True    False
Multiple Choice

1. The sale of merchandise by a company on its own credit card may result in a
   a. debit to Service Charge Expense.
   b. debit to Interest Expense.
   c. credit to Interest Revenue.
   d. credit to Cash.

2. A company has net credit sales of $600,000 for the year and it estimates that uncollectible
   accounts will be 2% of sales. If Allowance for Doubtful Accounts has a credit balance of
   $1,000 prior to adjustment, its balance after adjustment will be a credit of
   a. $12,000.
   b. $13,000.
   c. $11,000.
   d. some other amount.

3. Under the allowance method, the entry to write-off an uncollectible account results in
   a debit to
   a. Bad Debt Expense and a credit to Accounts Receivable.
   b. Bad Debt Expense and a credit to Allowance for Doubtful Accounts.
   c. Allowance for Doubtful Accounts and a credit to Bad Debt Expense.
   d. Allowance for Doubtful Accounts and a credit to Accounts Receivable.

4. A company sells $400,000 of accounts receivable to a factor for cash less a 2% service
   charge. The entry to record the sale should not include a
   a. debit to Interest Expense for $8,000.
   b. debit to Cash for $392,000.
   c. debit to Service Charge Expense for $8,000.
   d. credit to Accounts Receivable for $400,000.

5. When an interest-bearing note is dishonored at maturity and ultimate collection is expected,
   the entry for the dishonoring, assuming no previous accrual of interest should include
   a. a debit to Allowance for Doubtful Accounts.
   b. only a credit to Notes Receivable.
   c. a credit to Notes Receivable and Interest Revenue.
   d. a credit to Notes Receivable and Interest Receivable.
TRUE/FALSE

1. True  
2. True  
3. False  
4. True  
5. True

6. False  
7. True  
8. True  
9. False  
10. False

MULTIPLE CHOICE

1. c.  
2. b.  
3. d.  
4. a.  
5. c.