

# Chapter 8

# Receivables

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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*.

# 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.

# 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.

# 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*.

# 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.

# Uncollectible Receivables

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- Companies may shift the risk of uncollectible receivables to other companies by not accepting sales on account and only accepting cash or credit cards.
- Companies may also sell their receivables.
  - Selling receivables is called *factoring* the receivables.
    - The buyer of the receivables is called a *factor*.
    - An advantage of factoring is that the company selling its receivables immediately receives cash for operating and other needs.

# Uncollectible Receivables

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- Regardless of how careful a company is in granting credit, some credit sales will be uncollectible.
- The operating expense recorded from uncollectible receivables is called **bad debt expense**, *uncollectible accounts expense*, or *doubtful accounts expense*.

# 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.

# 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.

# Write-Offs to the Allowance Account

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- Because Allowance for Doubtful Accounts is based on an estimate, it will normally have a balance at the end of a period. As a result, 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.

# Write-Offs to the Allowance Account

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- An account receivable that has been written off against the allowance account may be collected later.

# 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.

# Percent of Sales Method

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

# Analysis of Receivables Method

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- 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.

# Analysis of Receivables Method

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- 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.

# Analysis of Receivables Method

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- The preceding steps are then summarized in an aging schedule, and this overall process is called **aging the receivables**.

# Aging of Receivables Schedule, December 31

	A	B	C	D	E	F	G	H	I
1			Not	Days Past Due					
2			Past						Over
3	<b>Customer</b>	<b>Balance</b>	<b>Due</b>	<b>1-30</b>	<b>31-60</b>	<b>61-90</b>	<b>91-180</b>	<b>181-365</b>	<b>365</b>
4	Ashby & Co.	1,500			1,500				
5	B. T. Barr	6,100					3,500	2,600	
6	Brock Co.	4,700	4,700						
7									
21									
22	Saxon Woods Co.	600					600		
Step 4 → 23	Total	240,000	125,000	64,000	13,100	8,900	5,000	10,000	14,000
Step 5 → 24	Percent uncollectible		2%	5%	10%	20%	30%	50%	80%
Step 6 → 25	Estimate of uncollectible accounts	26,490	2,500	3,200	1,310	1,780	1,500	5,000	11,200

# Analysis of Receivables Method

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- The sum of the estimated uncollectible accounts is the estimated uncollectible accounts on December 31.
- 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.

# Direct Write-Off and Allowance Methods

	<b>Direct Write-Off Method</b>	<b>Allowance Method</b>
Bad debt expense is recorded	When the specific customer accounts are determined to be uncollectible.	Using estimate based on (1) a percent of sales or (2) an analysis of receivables.
Allowance account	No allowance account is used.	The allowance account is used.
Primary users	Small companies and companies with few receivables.	Large companies and those with a large amount of receivables.

# Notes Receivable

- A note receivable has some advantages over an account receivable.
- 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.

# Characteristics of Notes Receivable

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- A promissory note is a written promise to pay the face amount, usually with interest, on demand or at a date in the future.

# Characteristics of Notes Receivable

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- 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.

# Promissory Note

③ Face Amount

⑥ Term

② Payee

④ Issuance Date

\$ 2,000.00

Fresno, California March 16 20 Y8

Ninety days

AFTER DATE We PROMISE TO PAY TO

THE ORDER OF Pearland Company

Two thousand 00/100----- DOLLARS

VALUE RECEIVED WITH INTEREST AT 10%

NO. 14 DUE June 14, 20Y8

H.B. Lane  
TREASURER, SELIG COMPANY

① Maker

⑤ Due Date

⑦ Interest Rate

# Characteristics of Notes Receivable

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- 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.

# Accounting for Notes Receivable

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- 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.

# Accounting for Notes Receivable

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- If the maker of the note fails to pay the note on the due date, it is considered a **dishonored note receivable**.
- A company that holds a dishonored note transfers the face amount of the note plus any interest due back to an accounts receivable account.

# Accounting for Notes Receivable

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- A company receiving a note should record an adjusting entry for any accrued interest at the end of the period.

# 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.

# Analysis for Decision Making: 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:

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

# Analysis for Decision Making: Number of Days' Sales in Receivables

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

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