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Research Article

Analysis of Notes Receivable in Company X

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Abstract

The main factor that influences the continuity of a business is sales, so that sales play the most important role in determining the progress of the company. The current trend is that credit sales are more attractive to consumers than cash sales. For companies with sales on credit will cause receivables, receivables include all activities both in the form of individuals, business entities or others.Receivables are one of the important instruments in the management of the company. The amount of the receivables greatly affects the company's performance, because for many companies, income from the sale of goods or services on credit is the largest element that affects the profits earned by the company.Overdue accounts receivable are sometimes converted into notes receivable, thereby giving the debtor more time to pay, while also sometimes including a personal guarantee by the owner of the debtor. Through the methods of observation, interviews, and literature, the authors evaluate the credit sales procedures that occur, record notes receivable accounting, report the preparation of notes receivable reports and analyze the obstacles that occur that affect the receivables management process.

Keywords: sales on credit, notes receivable, Bad Debt Expenses

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1. INTRODUCTION

Debts and receivables are a common thing in the world of trade or business. At this time, a company can grow fast if it can provide sales on credit to customers. That is what make accounts receivable in running its business. Overdue accounts receivable are sometimes converted into notes receivable, thereby giving the debtor more time to pay, while also sometimes including a personal guarantee by the owner of the debtor.

Notes receivable refers to a written, unconditional promise made by an individual or business to pay a definite amount at a definite date or on demand.The individual or business that signs the note is referred to as the maker of the note (Warae, 2021). The person to whom the payment is to be made is called the payee.

In other words, a note receivable is a lender's contract with the borrower. This will entitle the lender to receive principal and interest payments from the borrower in the future.They're shown in the balance sheet of the borrower as the current assets in case the note is due within the period of one year, else will be shown under the non-current assets in the balance sheet if the note is due after the period of one year.

This paper reviews the description and discussion ofcredit sales procedures that occur, record notes receivable accounting, report the preparation of notes receivable reports.

2. LITERATURE REVIEW

Notes receivable is a balance sheet item, which records the value of notes payable that the business owes and must receive payment. A written promissory note entitles the holder, or bearer, to receive the amount outlined in the legal agreement. A promissory note is a written promise to pay cash to another party on or before a certain date in the future. There are 3 conditions for recording notes receivable as follows:

- Provide loans and immediately recorded in notes
- There is a credit sale and it is recorded directly into a note
- Change from accounts receivable to notes receivable

There are main components of notes receivable :

1. Principal Value : it is the note’s face value.
2. Maker : the maker is the person who prepares the note. He, by preparing notes, promises to pay the specified amount to the holder of notes. For the maker, the note will be classified as the note payable.
3. Payee : the person to whom the maker issues the note is known as the payee. The payee holds the note with the right to receive the payment from the maker. For the maker, the note will be classified as the note receivable.
4. Stated Interest : in addition to the principal amount, the maker of note has an obligation to pay the interest amount due at the rate of interest, which is predetermined in the notes receivable. This predetermined interest rate is known as the stated interest.
5. Term : the length of time the note is paid. Notes receivable are usually not subject to a prepayment penalty, so the note maker is free to pay the note on or before the note's maturity, or maturity, date.

The payee is the party who receives payment under the terms of the note, and the maker is the party obligated to send funds to the payee. The amount of payment to be made, as listed in the terms of the note, is the principal. The principal is to be paid on the maturity date of the note.

When a note is received from maker, the notes receivable account is debited. The credit can be to cash, sales, or accounts receivable, depending on the transaction that gives rise to the note.In any event, the notes receivable account is at the face, or principal of the note. No interest income is recorded at the date of the issue because no interest has yet been earned.If the note extends beyond one period, interest is recorded at the maturity date or at the end of the accounting period using an adjusting entry.

A note receivable usually includes a specific interest rate, or a rate which is tied to another interest rate, such as a bank’s prime rate. The calculation of the interest earned on a note receivable is:

$$\text{Interest earned} = \text{Principal} \times \text{Interest rate} \times \text{Time period}$$

If an entity has a large number of notes receivable outstanding, it should consider setting up an allowance for doubtful notes receivable, in which it can accrue a bad debt balance that it can use to write off any notes receivable that later become uncollectible. An uncollectible note receivable is said to be a dishonored note.

3. METHODS

The descriptive approach was adopted in this study through the collection of previous literature and examples to illustrate what is notes receivable and how to mitigate the uncollectible receivables. This journal will provide sample case that may be occur in company.

The aim of the journal is to help users how to recording and reporting transactions about notes receivable in company from accounting side.

Methods for Estimating Uncollectible Notes Receivable
If the amount of notes receivable is significant, a company should establish a separate allowance for bad debts account for notes receivable.

Two methods for bad debts accounts as follows :

1. Allowance Method
   When it comes to large material amounts, the allowance method is preferred compared to the direct write-off method. The reason for the preference is because the method involves a contra asset account that goes against accounts receivables. A contra asset account named **allowance for bad debts**, which is sometimes called **allowance for doubtful accounts**, is subtracted from accounts receivable to show the net realizable value of accounts receivable on the balance sheet. This is also called the balance sheet approach.
   Under the allowance method, an adjustment is made at the end of each accounting period to estimate bad debts based on the business activity from that accounting period. The adjusting entry to estimate the expected value of bad debts does not reduce accounts receivable directly.
   Two ways to estimated the allowance for bad debts below like this :
   - Percentage of Sales
     It is computed as a percentage of credit sales. This way ignores the current balance of the allowance account. The percentage used is adjusted as needed to reflect collection experience.
     For the example :
     Total net credit sales of Company X for the year of 2019 were $800,000 and the estimated 1% of net credit sales are uncollectible.
     The journal to record the allowance for bad debts :

Dec 31,	Bad Debts Expense	$ 8,000	
	Allowance for Bad Debts		$ 8,000
	(To record the allowance for receivables)		
	Note : $ 800,000 X 1% = $ 8,000		

   - Aging of Receivables
     One way companies derive an estimate for the value of bad debts under the allowance method is to calculate bad debts as a percentage of the accounts receivable balance.
     For the example :
     Company X have current credit balance allowance of the bad debts amount of $ 12,500.
     In the 31 December 2019, Company X have estimated the aging of receivables as follows :

Length of Time	Amount of Receivable	% Uncollectible	Allowance for Bad Debts
1 – 30 Days	$ 600,000	1.0%	$ 6,000
30 – 90 Days	$ 300,000	2.5%	$ 7,500
91 – 120 Days	$ 100,000	4.0%	$ 4,000
>120 Days	$ 50,000	6.0%	$ 3,000
		Total	**$ 20,500**

In the December 31, Company X will adjusted the balance account allowance of the bad debts as :

Dec 31,	Bad Debts Expense	$ 8,000	
	Allowance for Bad Debts		$ 8,000

(To record the allowance for receivables)
Note : $ 20,500 - $ 12,500 = $ 8,000

2. Direct Write Off Method
   Another method to account for bad debts accounts is the direct write off approach. Under this method, a specific account receivable is removed from the accounting records at the time it is finally determined to be uncollectible. This is also called the income statement approach.
   For the example :
   Company X have an uncollectible notes receivable amount of $2,000. If Company X used this method, then the transactions will be recorded like this :

Dec 31,	Bad Debts Expense	$ 2,000	
	Notes Receivable		$ 2,000

(To write off uncollectible receivables)

Allowances for bad debts will be presented on the balance sheet in the current assets position as follows :

Company X
Statement of Financial Position
For the Year Ended December 31, 2019

<u>Assets :</u>

1. **Current Assets :**
   - Cash
   - Account Receivable
   - **Notes Receivable**
   - **(-) Allowances for Bad Debts**

   Net Realized Account Receivable
   - Inventory

   Total Current Assets
2. **Non Current Assets :**
   - Land
   - Building

   (-) Accumulated Depreciation
   - Investments

   Total Non Current Assets

Notes receivable less allowances for bad debts will will get the realizable value of notes receivable

TOTAL ASSETS

Bad debts expense will be presented on the income statement in the expense account as follows :

Company X
Income Statement
For the Year Ended January 01, 2019 - December 31, 2019

Sales

Cost of Goods Sold

Operational Expense :
- Salary Expense
- **Bad Debts Expense**
- Rent Expense
- Insurance Expense

Total Operational Expenses

Bad debts expense is the one of expense that decrease net income of the company

4. RESULTS DAN DISCUSSION
4.1. Result

All the transactions related to notes receivable must be can recorded and reported in the financial position statement of company.

Sample case for the conditions change from accounts receivable to notes receivable :
At 01 Augst 2020, Company X sells two units excavator to Amazone Equipment for $200,000, with payment due in 30 days. After 30 days of non-payment by Amazone Equipment, both parties agree that Amazone Equipment will issue a note payable with term 6 month to Company X for the principal amount $200,000, at an interest rate of 10%, for a total payment of $200,000 plus interest due for the next six months.

$200,000 Medan, **01 Sept 2020**

Principal Value

Date of Note

6 months after date **Amazone Equipment** promise to pay

Term

Maker

to the order of **Company X**

Payee

the principal amount with annual interest at **10%**

Stated Interest	**Amazone Equipment** Henry James

The proper journal entries for Company X to record the receipt of notes as follows :

Sept 1,	Notes receivable	$200,000	
	Account Receivables		$200,000
	(To convert the account receivable of $200,000 to notes receivable)		

On December 31, 2020, Company X will prepare financial statements so that it will make adjustments to notes receivable received on September 1, 2020. The adjustments that will be made are as follows :

Interest Revenue period 01 September 2020 until 31 December 2020 :

Interest = Principal x Interest rate x Time period
Interest = $200,000 x 10% x 120 / 360 days
Interest = **$6,667**

Dec 31,	Interest Notes Receivable	$6,667	
	Interest Revenue		$6,667
	(To record interest on notes to be received for a period of 4 months)		

Notes receivable and interest receivables will be presented on the balance sheet in the current assets position as follows :

Company X
Statement of Financial Position
For the Year Ended December 31, 2020

Assets :

1. **Current Assets :**
   - Cash
   - Account Receivable
   - **Notes Receivable** **$ 200,000**
   - **Interest Notes Receivable** **$ 6,667**
   - Inventory

   Total Current Assets

Presented at current asset because the term under 12 months

2. **Non Current Assets :**
   - Land
   - Building

   (-) Accumulated Depreciation
   - Investments

   Total Non Current Assets

TOTAL ASSETS

Liability & Equity :

1. **Liability :**

   Current Liability :
   - Account Payable
   - Accrual Expense

TOTAL LIABILITY

2. Equity - Capital - Retained Earnings - Profit of the year **TOTAL EQUITY** **TOTAL LIABILITY & EQUITY**

Interest revenue will be presented on the income statement in the other revenue as follows :

Company X **Income Statement** **For the Year Ended January 01, 2020 - December 31, 2020**		
Sales :		
- Gross Sales		
- (-) Discount & Return Sales		
Net Sales		
(-) Cost of Goods Sold		
Gross Profit		
(-) Operational Expense		Presented at other revenue because it is classified as non operational revenue
Net Profit Before Tax		
Other Revenue & Expense :		
- **Interest Notes Revenue**	**$ 6,667**	
- Other Revenue		
- (-) Other Expense		
Other Revenue & Expense Net		
Tax		
Net Profit After Tax		

When the note is due, Amazone Equipment has paid it off. Company X will record as follows :

Interest Revenue period 01 January 2021 until 01 February 2021 :

Interest = Principal x Interest rate x Time period
Interest = $200,000 x 10% x 60 / 360 days
Interest = **$3,333**

Feb 01,	Cash	$210,000	
	Notes Receivable		$200,000
	Interest Notes Receivable		$ 6,667
	Interest Revenue		$ 3,333
	(To record interest on notes to be received for a period of 4 months)		

There is a possibility that the notes payable issued by Amazone Equipment cannot be paid according to maturity (dishored notes). If the condition of dishonored notes like the case in upon happened, Company X have two choice of the recording like as :

1. **Estimed the receivable can still collectible**
   If payment is expected, the company transfers the principal and interest to accounts receivable, removes the value of the notes from notes receivable, and recognizes the interest revenue. In this case, Company X estimated receivables of Amazone Equipment are still collectible and Company X will record the transaction like below this :

Feb 01,	Account Receivable	$210,000	
	Notes Receivable		$200,000
	Interest Notes Receivable		$ 6,667
	Interest Revenue		$ 3,333

(Notes receivables from Amazone Equipment that can't paid but still collectible)

2. **Estimated the receivable uncollectible**

If Amazone Equipment dishonored the notes and Company X believes the note is a bad debt and really uncollectible again, then Company X will record the transaction as follows :

Feb 01,	Allowance for Bad Debts	$200,000	
	Notes Receivable		$200,000

(Uncollectible notes receivables from Amazone Equipment)

In this case, no interest revenue is recognized because none will ever be received. If interest on a bad debt had previously been accrued, then a correcting entry is needed to remove the accrued interest from interest revenue and interest receivable (by debiting interest revenue and crediting interest receivable). Although interest revenue would have been overstated in the accounting periods when the interest was accrued and would be understated in the period when the correcting entry occurs.

Accounts Previously Written Off can be Recovery

On occasion, a company may collect an account that was previously written off. For example, on 20 December 2022 Amazone Equipment financial condition may suddenly recover, and pay an amount that was previously written off. The entry to record the recovery involves two steps :

1. A reversal of the entry that was made to write off the account

Dec 20,	Notes Receivable	$200,000	
	Bad Debt Recovered		$200,000

(Recovery notes receivables from Amazone Equipment)

2. Recording the cash collection on the account:

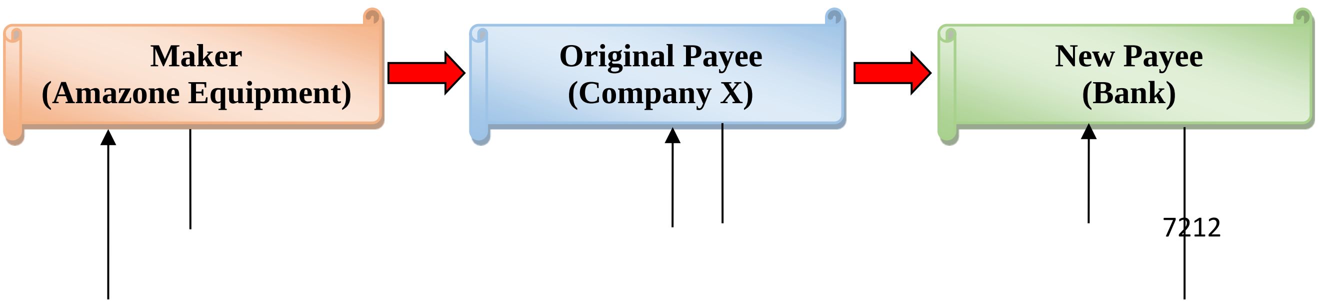
Dec 20,	Cash	$200,000	
	Notes Receivable		$200,000

(To record collection of notes receivables from Amazone Equipment)

Discounting Notes Receivable

Just as accounts receivable can be factored, notes can be converted into cash by selling them to a financial institution at a discount. Notes are usually sold (discounted) with recourse, which means the company discounting the note agrees to pay the financial institution if the maker dishonors the note.

The discount rate is the annual percentage rate that the financial institution charges for buying a note and collecting the debt. The discount period is the length of time between a note's sale and its due date. The discount, which is the fee that the financial institution charges, is found by multiplying the note's maturity value by the discount rate and the discount period.



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Example :
Suppose from the case above this, after received notes from Amazone Equipment amount of $200,000 with term six month at an interest rate of 10% Company X sells the notes to the Bank Central Asia to obtain immediate cash. For this transaction, Bank Central Asia offers 17% discount rate.

Principal	$ 200,000
Interest ($ 200,000 X 10% X 6/12)	$ 10,000
Maturity Value	$ 210,000

If bank offers 17% discount rate, the bank's discount is $ 17,850.
$ 210,000 X 17% X 6/12 = $ 17,850

The bank subtracts the discount from the note's maturity value and pays Company X $ 192,150 for the note.

Maturity Value	$ 210,000
Discount	($ 17,850)
Discounted Value of Note	$ 192,150

Since the company discounts the note before earning any interest revenue, interest expense is $ 7,850 ($ 200,000 - $ 192,150)
Company X will record the transaction as like :

Sept 01,	Cash	$ 192,150	
	Interest Expense	$ 7,850	
	Notes Receivable		$ 200,000
	(Sells notes received from Amazone Equipment)		

Suppose the Company X holds the note for four month before discounting it. After four month, Company X has earned interest revenue of $ 6,667 ($ 200,000 X 10% X 4/12 month).

The bank's discount is $ 210,000 X 17% X 2/12 = $ 5,950

The bank will pays Company X $ 204,050 for the note.

Maturity Value	$ 210,000
Discount	($ 5,950)
Discounted Value of Note	$ 204,050

Company X will record the transaction as like :

Jan 02,	Cash	$ 204,050	
	Interest Expense	$ 2,617	
	Notes Receivable		$ 200,000
	Interest Revenue		$ 6,667
	(Sells notes received from Amazone Equipment)		

Note : Interest Expense = ($ 200,000 + $ 6,667) - $ 204,050 = $ 2,617

4.2. Discussion

Long time ago, receivables has focused on accounts receivable. Company can expand their business models to include more than one type on receivable like notes receivable. This receivable allows company to attract a more diverse customer and increase asset potential to further grow the business.

Now businesses often allow their customer to convert their receivables, which are overdue into the notes receivable due to which it provides more time for the repayment. They are shown in the statement of financial position.

One of the differences between notes receivable and accounts receivable is the greater negotiability of notes. A holder of a note can readily convert it to cash by discounting it at a bank. After the notes sell to the bank, bank will receive payment as the amount from the maker when due date. But if the maker can’t paid Company X (original payee) will paid to the bank.

The notes provides all the terms and conditions clearly so that there should not be any ambiguity in the future between the two parties. It also clearly mentions the interest which is required to be paid along with the principal amount, which is the face value of the notes. Notes receivable also not subject to the prepayment penalties. In this case, the maker of note can pay off the amount on before the maturity date freely, which can save the interest amount.

5. CONCLUTION

Receivables are financial instruments according to the defintion in IAS 32.11 : A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another company. Receivables are recorded if conditions for revenue recognition are met but cash inflow has not yet occurred.

Notes receivable must count the interest income that will be received by the company with term. A note is often referred to as a promissory note. The main components of a note receivable are principal amount, maker, payee, interest and term. Notes receivable balances are reported in the statement of financial position (balance sheet) as current assets if they mature within 12 months or as non-current assets if they mature more than 12 months. For the interest revenue from the notes, will be reported in the income statement.

Notes that issued have risk that uncollectible so company must consider setting up methods for estimating uncollectible receivables. In accounting, to estimate the uncollectible receivable have 2 methods : allowance method and direct write off method. Allowance Method prefer used compared than direct write off method.

Transactions case of Company X in this journal about notes receivable have illustrate how the company record the transaction, how company setting and record the uncollectible method, how the receivables had write off can be recovery and how company reported the balance of notes receivable. In this paper also illustrate how company can sell the notes that received before maturity date to obtain immediate cash. This case can be used when company have these transaction and can help in preparation financial statements.

The financial statements are viewed by investors and potential investors. The report need to be reliable and must possess integrity because investors will make decision to make investment or not to the company. The amount of receivables and the ability to collect these receivables are one tool that can affect investors decisions.

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