

14. Notes Receivable

A written promise from a client or customer to pay a definite amount of money on a specific future date is called a note receivable. Such notes can arise from a variety of circumstances, not the least of which is when credit is extended to a new customer with no formal prior credit history. The lender uses the note to make the loan more formal and enforceable. Such notes typically bear interest charges. The maker of the note is the party promising to make payment, the payee is the party to whom payment will be made, the principal is the stated amount of the note, and the maturity date is the day the note will be due.

Interest is the charge imposed on the borrower of funds for the use of money. The specific amount of interest depends on the size, rate, and duration of the note. In mathematical form: Interest = Principal X Rate X Time. For example, a \$1,000, 60-day note, bearing interest at 12% per year, would result in interest of \$20 ($\$1,000 \times 12\% \times 60/360$). In this calculation, notice that the “time” was 60 days out of a 360 day year. Obviously, a year normally has 365 days, so the fraction could have been 60/365. But, for simplicity, it is not uncommon for the interest calculation to be based on a presumed 360-day year or 30-day month. This presumption probably has its roots in olden days before electronic calculators, as the resulting interest calculations are much easier with this assumption in place. But, with today’s technology, there is little practical use for the 360 day year, except that it tends to benefit the creditor by producing a little higher interest amount -- caveat emptor (Latin for “let the buyer beware”)! The following illustrations will preserve this archaic approach with the goal of producing nice round numbers that are easy to follow.

14.1 Accounting for Notes Receivable

To illustrate the accounting for a note receivable, assume that Butchko initially sold \$10,000 of merchandise on account to Hewlett. Hewlett later requested more time to pay, and agreed to give a formal three-month note bearing interest at 12% per year. The entry to record the conversion of the account receivable to a formal note is as follows:

6-1-X8	Notes Receivable	10,000	
	Accounts Receivable		10,000
	<i>To record conversion of an account receivable to a note receivable</i>		

When the note matures, Butchko’s entry to record collection of the maturity value would appear as follows:

8-31-X8	Cash	10,300	
	Interest Income		300
	Notes Receivable		10,000
	<i>To record collection of note receivable plus accrued interest of \$300 ($\\$10,000 \times 12\% \times 90/360$)</i>		

14.2 A Dishonored Note

If Hewlett dishonored the note at maturity (i.e., refused to pay), then Butchko would prepare the following entry:

8-31-X8	Accounts Receivable	10,300	
	Interest Income		300
	Notes Receivable		10,000
<i>To record dishonor of note receivable plus accrued interest of \$300 (\$10,000 X 12% X 90/360)</i>			

The debit to Accounts Receivable in the above entry reflects the hope of eventually collecting all amounts due, including the interest, from the dishonoring party. If Butchko anticipated some difficulty in collecting the receivable, appropriate allowances would be established in a fashion similar to those illustrated earlier in the chapter.

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14.3 Notes and Adjusting Entries

In the above illustrations for Butchko, all of the activity occurred within the same accounting year. However, if Butchko had a June 30 accounting year end, then an adjustment would be needed to reflect accrued interest at year-end. The appropriate entries illustrate this important accrual concept:

Entry to set up note receivable:

6-1-X8	Notes Receivable	10,000	
	Accounts Receivable		10,000
	<i>To record conversion of an account receivable to a note receivable</i>		

Entry to accrue interest at June 30 year end:

6-30-X8	Interest Receivable	100	
	Interest Income		100
	<i>To record accrued interest at June 30 (\$10,000 X 12% X 30/360 = \$100)</i>		

Entry to record collection of note (including amounts previously accrued at June 30):

8-31-X8	Cash	10,300	
	Interest Income		200
	Interest Receivable		100
	Notes Receivable		10,000
	<i>To record collection of note receivable plus interest of \$300 (\$10,000 X 12% X 90/360); \$100 of the total interest had been previously accrued</i>		

The following drawing should aid your understanding of these entries:

