

# ACCOUNTING FOR NOTES RECEIVABLE

## Key Terms and Concepts to Know

### Notes Receivable:

- May have any duration from a day or two up to many years.
- Long-term notes receivable may be used to finance the purchase of a long-lived asset such as a car.
- Notes bear interest for their term that is paid at the end of the term, the maturity date.
- Interest rates are typically stated as a percent per annum, that is, as a yearly or annual rate.
- Interest revenue is earned as time passes, regardless of whether payment has been received.
- Interest revenue for outstanding notes receivable is typically accrued at the end of the year, although it may be accrued at the end of a quarter or month.

### Short-term Notes Receivable:

- Short-term notes receivable are frequently accepted by the seller in payment for a sale or to replace an account receivable from a prior sale.
- If the short-term note is not paid or dishonored at maturity, the seller debits accounts receivable for the amount of the principal and interest because it is still owed to the seller by the buyer. In place of the account receivable, the seller may also accept another note receivable.
- Short-term notes are repaid at maturity including interest.

## Key Topics to Know

### Notes Receivable

A Promissory Note is a written promise to pay a specific dollar amount on demand or at a specific time, usually with interest.

- If the note is paid according to the terms, the note is honored.
- If the note is not paid as agreed according to the terms, the note is dishonored.
- If the note is dishonored, the amount due including the interest earned and unpaid is recorded in accounts receivable.

At the end of the accounting period, in order to comply with the matching principle, interest must be accrued for the number of days between the most recent interest payment date and the end of the accounting period using the calculation method shown above.

#### **Example #1**

On July 17, K Company received a \$12,000, 90-day, 10% note on account from M Company.

Required: Determine:

- a) Due date for the note
- b) Interest earned during the term of the note
- c) Maturity value of the note

Prepare journal entries whether:

- d) The note is honored on the maturity date
- e) The note is dishonored on the maturity date

**Solution #1**

- a) Due Date:
- |                                  |           |
|----------------------------------|-----------|
| Term of the note =               | 90        |
| Days remaining in July 31 – 17 = | <u>14</u> |
| Remaining term of the note       | 76        |
| Days in August                   | 31        |
| Remaining term of the note       | 45        |
| Days in September                | 30        |
| Remaining term of the note       | 15        |
- Since the remaining 15 days are less than the 31 days in October, the note is due on October 15.

- b) Interest:
- Calculated as Principal X Rate X Time
- $$\$12,000 \times .10 \times 90 \text{ days}/360 \text{ days} = \$300$$
- Time is calculated as the term of the note divided by 360 days for the year.
- Time is always based on a 360-day year.

- c) Maturity Value:
- Calculated as Principal + Interest
- $$\$12,000 + \$300 = \$12,300$$

- d) Note is honored:
- |       |                     |        |        |
|-------|---------------------|--------|--------|
| 7/17  | Notes receivable    | 12,000 |        |
|       | Accounts receivable |        | 12,000 |
| 10/15 | Cash                | 12,300 |        |
|       | Notes receivable    |        | 12,000 |
|       | Interest receivable |        | 300    |

- e) Note is dishonored:
- |       |                     |        |        |
|-------|---------------------|--------|--------|
| 7/17  | Notes receivable    | 12,000 |        |
|       | Accounts receivable |        | 12,000 |
| 10/15 | Accounts receivable | 12,300 |        |
|       | Notes receivable    |        | 12,000 |
|       | Interest receivable |        | 300    |

The difference between the two entries for 10/15 is the account to be debited.

**Example #2**

T Company accepted a \$12,000, 90-day, 15% note dated October 22 and a \$24,000, 60-day, 10% note dated December 1.

- Required:
- Prepare the adjusting entry for accrued interest on December 31
  - Journalize the receipt of cash on the due date for each note.

**Solution #2**

- a) Interest has been earned for 30 days  
Days remaining in December 31 – December 1 = 30 days

Interest earned:

$$\$24,000 \times .10 \times 30 \text{ days} / 360 \text{ days} = \$200$$

Interest receivable	200	
Interest revenue		200
Cash	24,400	
Notes receivable		24,000
Interest revenue <i>for January</i>		200
Interest receivable		200

- b) Interest has been earned for 30 days  
Days remaining in October 31 – October 22 = 9 days  
Days in November = 30 days  
Days in December = 31 days  
Total days to accrue 70 days

Interest earned:

$$\$12,000 \times .15 \times 70 \text{ days} / 360 \text{ days} = \$350$$

Interest receivable	350	
Interest revenue		350
Cash	12,450	
Notes receivable		12,000
Interest revenue <i>for January 1</i>		100
Interest receivable		350

## Practice Problems

### **Practice Problem #1**

S Company was a party to the following transactions.

- a) 9/12 Received a \$30,000, 12%, 120-day note on account.
- b) 10/9 Received a \$15,000, 10%, 60-day note on account.
- c) 11/15 Received an \$18,000, 15%, 30-day note on account.
- d) 12/8 Received the amount due on the note of October 9.
- e) 12/15 The note of November 15 was dishonored.
- f) 12/31 Accrued interest on the note of September 12.

Required: Journalize the transactions

### **Practice Problem #2**

The following series of transactions occurred during Year 1 and Year 2, when F Company sold merchandise to L Company. F Company's annual accounting period ends on December 31.

#### Year 1

- 10/01 Sold \$12,000 of merchandise to L Company, terms 2/10, n/30.
- 11/15 L Company reports that it cannot pay the account until early next year and agrees to exchange the account for a 120-day, 12% note receivable.
- 12/31 Prepared the adjusting journal entry to record accrued interest on the note.

#### Year 2

- 03/15 F Company receives a check from L Company for the maturity value (with interest) of the note.

Required: Journalize the transactions

## True / False Questions

1. Notes receivable are similar to accounts receivable but are more formal credit arrangements evidenced by a written debt instrument, or note.  
True   False
2. Notes receivable only arise from sales to customers.  
True   False
3. Notes receivable typically earn interest revenue for the lender and interest expense for the borrower.  
True   False
4. A \$10,000 note that has a stated interest rate of 10% and is due in six months would have interest of \$1,000.  
True   False
5. Accrued interest on a note receivable is interest earned by the end of the year but not yet received.  
True   False
6. The interest rate for a note receivable is always stated for the term of the note.  
True   False
7. A 90-day note receivable dated February 1 is due on April 30, three months later.  
True   False
8. The debtor pays interest every month for a short-term note receivable.  
True   False

## Multiple Choice Questions

1. The face amount of a note plus interest earned on the due date is called the:
  - a) Realizable value
  - b) Face value
  - c) Net realizable value
  - d) Maturity value
  
2. When a 30 day \$7,000 12% note is dishonored, the required journal entry is:
  - a) Debit Cash 7,070; Credit Notes Receivable 7,070
  - b) Debit Accounts Receivable 7,070; Credit Notes Receivable 7,000; Credit Interest Revenue 70.
  - c) Debit Notes Receivable 7,070; Credit Accounts Receivable 7,070
  - d) Debit Accounts Receivable 7,070; Credit Notes Receivable 7,000; Credit Interest Receivable 70.
  
3. A short-term note receivable is recorded at its
  - a) Face Value
  - b) Fair market value
  - c) Present value
  - d) Maturity value
  
4. A 90-day note dated April 13 has a maturity date of
  - a) July 10
  - b) July 11
  - c) July 12
  - d) July 13
  
5. The interest on a \$6,000, 8%, 240-day note receivable is
  - a) \$320
  - b) \$480
  - c) \$32
  - d) \$48
  
6. W Company accepted a \$3,000, 120-day 10% note in payment of its account receivable. What entry will W Company make when it receives the note?
  - a) Debit Notes Receivable, 3,100; Credit Accounts Receivable 3,100
  - b) Debit Notes Receivable, 3,100; Credit Accounts Receivable 3,000
  - c) Debit Notes Receivable, 3,000 and Interest Receivable, 100; Credit Accounts Receivable, 3,000 and Interest Revenue, 100
  - d) Debit Notes Receivable, 3,000; Credit Accounts Receivable, 3,000

The next 2 questions refer to the following information.

V Company accepted a \$30,000, 120-day 10% note on November 15 in payment of its account receivable.

7. What is the amount of interest W Company will accrue on December 31?
  - a) \$250.00
  - b) \$375.00
  - c) \$1,125.00
  - d) \$500.00
  
8. On December 31, W Company will debit and credit the following accounts:
  - a) Debit Notes Receivable; Credit Interest Revenue
  - b) Debit Interest Receivable; Credit Interest Revenue
  - c) Debit Interest Revenue; Credit Interest Receivable
  - d) Debit Cash; Credit Interest Revenue



## Solutions to Practice Problems

### Practice Problem #1

a)	09/12	Notes Receivable	30,000	
		Accounts Receivable		30,000
b)	10/09	Notes Receivable	15,000	
		Accounts Receivable		15,000
c)	11/15	Notes Receivable	18,000	
		Accounts Receivable		18,000
d)	12/08	Cash	15,250	
		Notes Receivable		15,000
		Interest Revenue		250
		<i>(15,000 * .10 * 60/360 = \$250 interest)</i>		
e)	12/15	Accounts Receivable	18,225	
		Notes Receivable		18,000
		Interest Revenue		225
		<i>(18,000 * .15 * 30/360 = \$225 interest)</i>		
f)	12/31	Interest Receivable	1,100	
		Interest Revenue		1,100
		<i>Sept 12 – Dec 31 = 110 days</i>		
		<i>30,000 * .12 * 110/360 = \$1,100 interest</i>		

**Practice Problem #2**

<u>Year 1</u>			
Oct. 1	Accounts Receivable	12,000	-
	Sales		12,000
Nov. 15	Notes Receivable	12,000	
	Accounts Receivable		12,000
Dec. 31	Interest Receivable	184	
	Interest Revenue		184
	<i><math>\\$12,000 * .12 * (46/360) = \\$184</math></i>		
<u>Year 2</u>			
Mar. 15	Cash	12,480	-
	Notes Receivable		12,000
	Interest Receivable		184
	Interest Earned		296
	<i><math>\\$12,000 * .12 * (74/360) = \\$296</math></i>		

## Solutions to True / False Problems

1. True
2. False – notes receivable typically arise from loans to other entities including affiliated companies, loans to stockholders and employees as well as from the sale of merchandise or services.
3. True
4. False – interest = principle (\$10,000) × annual interest rate (10%) × fraction of year (6/12) = \$500.
5. True
6. False – Interest rates are always stated per annum (for a year), regardless of the term of the note.
7. False – the note would be due on May 2 as 28 days in February + 31 Days in March + 30 days in April = only 89 days. Adding one more day, May 1, equals 90 days.
8. False – interest is typically paid at the end of the term of the note.

## Solutions to Multiple Choice Questions

- |    |   |
|----|---|
| 1. | D |
| 2. | B |
| 3. | A |
| 4. | C |
| 5. | A |
| 6. | D |
| 7. | B |
| 8. | B |