**Notes Payable & Receivable Script**

Slide 1: In this short presentation, we will look at notes payable and receivable.

Slide 2: What exactly is a note? Notes are signed promises to repay a loan, including the amount borrowed, the interest rate and the time period involved. For this reason, they are sometimes referred to as ‘promissory notes.’

If you are the borrower, the note is a liability and is called a note payable. If you are the lender, the note is an asset, and is called a note receivable.

Most notes are for periods of less than one year; however, they can be for longer periods.

We will focus on Simple Interest Notes, however, I will compare to Simple Discount Notes at the end of the presentation.

Slide 3: We use the term “simple” interest because interest is only figured on time (as opposed to compound interest, where it is figured more often).

The Simple Interest Formula is **Interest = Principle \* Interest \* Time** where:

Principle is the amount borrowed or lent

 Interest is the annual percentage rate

 Time is expressed in years or fractions of years

We use 30 days for each month and 360 days for an entire year for ease of computation – this goes back to the days before calculators and computers.

At the end of the period, the borrower repays the principal and interest to the lender.

Slide 4: Let’s do a quick example: Assume that on January 1st, $20,000 is borrowed at 6.0% interest for a period of three months. How much interest will be due at the end of the period?

If we plug the numbers into the simple interest formula, we get 20,000 times 6.0% times 90 days divided by 360. This gives us interest of 300.

Slide 5: Let’s take the preceding example and prepare journal entries from the standpoint of the Borrower and the Lender. If you want to work along, I’ve prepared two journals – one for the Borrower and one for the Lender.

On the 1st, the day the note originates, the borrower records the cash received with a debit and credits the notes payable liability. The lender records the A/R asset with a debit and credits Cash to reflect its reduction.

On the 31st, at the end of the first full month, the lender incurs one month of interest expense, to be paid at maturity. This requires a credit to interest payable. The lender accrues that interest with a receivable and recognizes the interest income – they have provided the loan and have earned the revenue.

On the 28th, we do exactly the same journal entry for both the borrower and lender.

On March 31st, the maturity date, the borrower repays the note. This is journalized by recording the last month of interest expense with a debit, a debt to interest payable – we reduce that liability because the interest is paid, and a debit to notes payable, as that liability has also been satisfied. Finally, cash is credited to reflect the reduction in that asset.

The lender records the March 31st transaction with a debt to cash, a credit to interest income to recognize the last month of that revenue earned, a credit to interest receivable as that has now been satisfied, and a credit to the note, as that has also been repaid.

I hope this helps you. When I was studying notes, I found setting them side by side really helped me see what was happening – a note payable to the borrower is a note receivable to the lender, and so on.

Slide 6: I want to quickly show the difference between a Simple Interest Note and a Simple Discount Note. I used the same note we’ve been using all along for simplicity’s sake.

On the left is the Simple Interest Note. We see the 300 in interest, the 20,300 maturity value, and so on. At the bottom, I’ve restated the formula to solve for the Interest rate; we can see it’s 6.0%.

On the right, we see the Simple Discount Note. The amount of interest to be paid by the borrower is the same; however, we see that the maturity value differs by that same 300. A further look at proceeds explains why: the note is “discounted” by the amount of interest. As such, the borrower has only 19,700 to use and must repay 20,000 at the end of the three months. What is most instructive here is the effective interest rate – if we plug in the numbers, we can see that with this note, the borrower is paying slightly more than 6%.

The borrower would prefer the simple interest note and the lender would prefer the discount note. So, if someone offers to extend you financing with a note, make sure you understand whether it’s simple interest or simple discount.

I hope this has helped in your understanding of notes. Good luck with your studies.