CHAPTER 7 - Cash and Receivables

The next six chapters in our text all relate to assets. In general, these chapters are covered in the order that the assets appear on the Balance Sheet. Chapter 7 covers cash (Section 1) and receivables (Section 2). Cash and receivables represent two of the most liquid of assets. **Liquidity** is an indication of an enterprise's ability to meet its obligations as they come due.

I. Cash - Readily available for payment of current obligations and free from restrictions.

A. Nature of Cash

Cash includes:

< coin and currency, including petty cash and change funds
< bank deposits including checking and savings accounts
< negotiable instruments such as money orders, cashiers' checks, personal checks, and bank drafts.
< money market funds with check writing privileges

Cash does not include:

< Postdated checks and I.O.U.s (Receivables)
< Travel advances to employees (Receivables or prepaid expenses)
< Postage stamps on hand (office supplies or prepaid expenses)
< C Ds and short-term paper (temporary investments). Sometimes included with cash and referred to as Cash Equivalents.

Other considerations:

1. Bank overdrafts should be reported as current liabilities.

   Exception: They may be offset against the cash account if there is available cash in another account at the ***<u>same bank</u>***.

2. Restricted cash

   Cash restricted for some special purpose (such as the retirement of bonds) is **reported separately** in either the **current** asset section or the **noncurrent** asset section of the balance sheet, depending on the date of availability or disbursement.

3. Compensating balances against borrowing arrangements

   SEC suggests that this cash be reported separately in either the **current** asset section or the **noncurrent** asset section, depending on whether the borrowing arrangement is short-term or long-term. (See Exercise 1)

B. Control of Cash

Cash requires special controls, because:

< involved in almost all transactions
< easily concealed, converted and transported
< both ***too much*** and ***too little*** cause problems

Many **control procedures** exist for cash transactions. Two that are discussed in your text are:

< petty cash system - See Appendix 7A
< bank reconciliations

Bank Reconciliation

In this class we will reconcile both the bank statement balance and the book balance to the corrected cash balance.

Balance per bank statement	$XXX
Add: Deposits recorded by business but not by bank (Example: Deposits in transit)	XXX
Deduct: Charges recorded by business but not by bank (Example: Outstanding checks)	(XXX)
Corrected balance	$XXX

Balance per books (Cash account in the General Ledger)	$XXX
Add: Deposits recorded by bank but not by business (Example: Note collection)	XXX
Deduct: Charges recorded by bank but not by business (Examples: Service charges, NSF checks)	(XXX)
Corrected balance	$XXX

< Both sections end with the correct cash balance, which is the amount that should be reported on the balance sheet.

< Every reconciling item that appears in the "balance per books" section requires an adjusting entry to bring the books to the correct cash balance. (See Problem 12)

II. **Receivables:**

Claims held against customers and others for money, goods, or services. Classified as either trade or nontrade.

Accounts receivable - **Oral** promises to pay for goods and services sold.
Notes receivable - **Written** promises to pay a on a specified future date.

Two topics we must consider regarding receivables:

A. Recognition Issues

1. Trade Discounts - Reductions from the list price. Not recorded.

2. Cash Discounts (Sales Discounts) - Inducements for prompt payment.

There are two methods available to deal with Cash or Sales discounts:

Gross Method

To record sale:

Accounts Rec.	(@ gross)	
Sales		(@ gross)

To record collection within the discount period:

Cash	(@ net)	
Sales Discount	(a contra-revenue account)	
Accounts Rec.		(@ gross)

To record collection after the discount period:

Cash	(@ gross)	
Accounts Rec.		(@ gross)

Net Method

To record sale:

Accounts Rec.	(@ net)	
Sales		(@ net)

To record collection within the discount period:

Cash	(@ net)	
Accounts Rec.		(@ net)

Net Method (continued)

To record collection after the discount period:

When discount period expires:

Accounts Rec. (for the amount of the discount)
    Sales Discounts Forfeited (an Other Revenue account)

Upon collection:

Cash (@ gross)
    Accounts Rec. (@ gross)

The gross method is more practical, but the net method is theoretically superior.

Why? Think about chapter 6. (See EXERCISE 5)

B. Accounts Receivable—**Valuation** Issues.

Receivables are always reported on the Balance Sheet at **net realizable value** (the net amount expected to be received in cash).

1. Methods of accounting for uncollectible accounts:

    a. **Direct write-off method**—When an account is determined to be uncollectible:

    Bad Debt Expense XX
        Accounts Receivable XX

    This method is theoretically undesirable because it:

    1. does not match revenues and expenses.

    2. does not result in receivables being stated at net realizable value in the balance sheet.

b. **Allowance method**—At the end of each accounting period an estimate is made of expected losses from uncollectible accounts.

Two methods of estimating bad debt expense under the allowance method.

1. **Percentage-of-Sales** (Income Statement Approach). Bad debt expense is estimated directly by multiplying a percentage times credit sales.

2. **Percentage-of-Receivables** (Balance Sheet Approach):

   a. Allowance for Doubtful Accounts is estimated by multiplying a percentage times the ending outstanding receivables.

   b. Bad Debt Expense = the difference between the required ending balance and the existing balance in the Allowance account. (See EXERCISE 7)

C. Accounts and Notes Receivable—**Disposition** Issues. In order to accelerate the receipt of cash from receivables, they may be transferred to a third party for cash.

1. **Assignment** (Pledging). The owner of the accounts receivable borrows cash by writing a promissory note designating the accounts receivable as collateral.

   a. General assignment: All the accounts receivable serve as collateral for the note. New accounts receivable can be substituted for the ones collected.

   b. Specific assignment: The borrower and lender agree as to the specific accounts that serve as security. The assignor typically makes collections on the assigned accounts and remits the collections plus a finance charge (interest cost) to the lender.

2. **Sale** (Factoring). These transfers of accounts and notes receivable may be without recourse or with recourse.

   a. **Transfer Without Recourse**—The purchaser assumes the risk of collectibility and absorbs any credit losses. This is an outright sale of receivables both in **form** and **substance.** A **loss on the sale** is recognized for the excess of the face amount of the receivables over the cash proceeds.

b. **Transfer With Recourse**—The seller **guarantees** payment to the purchaser for those receivables which become uncollectible.

   1. A controversy exists as to whether these transfers should be recorded as a **sale** (with recognition of gain or loss) or as a collateralized **borrowing** (with recognition of a liability).

   2. In *SFAS No. 77* the FASB required that these transfers be recognized as a **sale** if all three of the following conditions are met:

      a. The transferor surrenders control of the future econ. benefits of the receivables.

      b. The transferor's obligations under the recourse provisions can be reasonably estimated.

      c. The transferee cannot **require** the transferor to repurchase the receivables.

   3. If the transfer with recourse does not meet these three conditions, the transaction is accounted for as a borrowing and a liability is recorded.

EXERCISES 10, 11 AND 13

D. Notes Receivable—**Recognition** Issues. The present value of the future cash flows is the proper amount to record for notes.

   1. Review the terminology in accounting for notes:

      a. **Face amount**—The principal amount due that is stated on the face of the note. The debit balance of the Notes Receivable account is always equal to the face amount.

      b. **Stated rate of interest**—The rate that is stated on the face of the note. This rate is used to determine the amount of periodic interest payments. A note may be non-interest-bearing (i.e. have a stated rate of zero).

      c. **Effective (market) rate of interest**—This is the rate that is used to look up present value factors in order to account for the note at the date of issuance.

d. **Present value**—At the date of issuance, a note is valued at the present value of the future principal and interest cash flows, discounted at the market rate of interest. Changes in the market rate of interest are ignored throughout the remainder of the life of the note.

e. **Discount on notes receivable**—At the date of issuance, this represents the excess of the face amount of the note over the present value. A discount arises because the market rate is greater than the stated rate of interest. The Discount on Notes Receivable account is a valuation (contra-asset) account with a credit balance.

f. **Premium on notes receivable**—At the date of issuance, this presents the excess of the present value of the note over the face amount. A premium arises because the market rate is less than the stated rate. The Premium on Notes Receivable account has a debit balance.

g. **Net carrying amount of the note**—This is the amount at which notes are reported on the balance sheet. It is equal to the face amount of the note less the unamortized discount or plus the unamortized premium.

h. **Amortization**—The process of writing off the discount or premium over the life of the note. The effective interest method of amortization should be used.

i. **Effective interest method**—Amortization method which determines periodic interest revenue by applying a constant interest rate to the net carrying amount of the note. The dollar amount of interest revenue changes each period as the net carrying amount of the note changes.