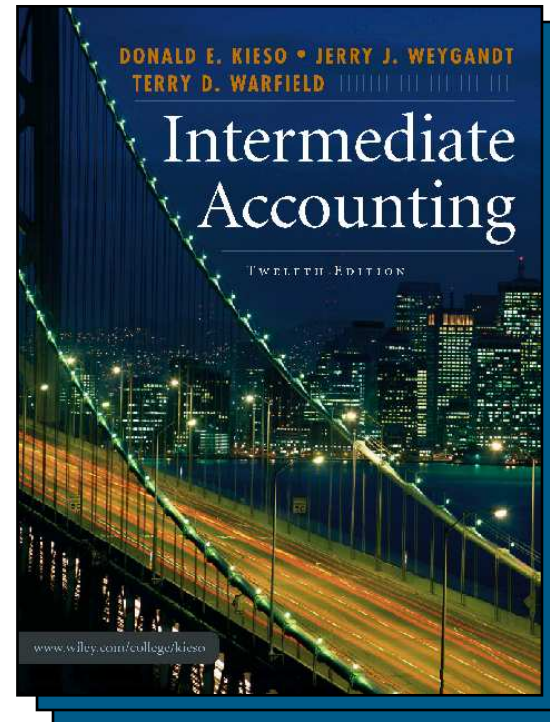


Understanding Cash and Receivables

Chapter 7

Intermediate Accounting
12th Edition
Kieso, Weygandt, and Warfield



Learning Objectives

1. Identify items considered as cash.
2. Indicate how to report cash and related items.
3. Define receivables and identify the different types of receivables.
4. Explain accounting issues related to recognition of accounts receivable.
5. Explain accounting issues related to valuation of accounts receivable.
6. Explain accounting issues related to recognition of notes receivable.
7. Explain accounting issues related to valuation of notes receivable.
8. Explain accounting issues related to disposition of accounts and notes receivable.
9. Describe how to report and analyze receivables.

Cash and Receivables

Cash

- What is cash?
- Management and control of cash
- Reporting cash
- Summary of cash-related items

Receivables

- Recognition of accounts receivable
- Valuation of accounts receivable
- Recognition of notes receivable
- Valuation of notes receivable
- Disposition of accounts and notes receivable
- Presentation and analysis

What is Cash?

Cash

- Most liquid asset
- Standard medium of exchange
- Basis for measuring and accounting for all items
- Current asset
- **Examples:** coin, currency, available funds on deposit at the bank, money orders, certified checks, cashier's checks, personal checks, bank drafts and savings accounts.

Management and Control of Cash

Management faces two problems:

- (1) to establish proper controls to prevent any unauthorized transactions, and
- (2) to provide information necessary to the proper management of cash on hand and cash transactions.

Companies need effective internal control over cash.

Reporting Cash

Restricted Cash

Companies segregate restricted cash from “regular” cash for reporting purposes.

Examples, restricted for:

- (1) plant expansion, (2) retirement of long-term debt, and
- (3) compensating balances.

Illustration 7-1

International Thoroughbred Breeders

Restricted cash and investments (See Note)	\$3,730,000
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Note: Restricted Cash. At year-end, the Company had approximately \$3,730,000, which was classified as restricted cash and investments. These funds are primarily cash received from horsemen for nomination and entry fees to be applied to upcoming racing meets, purse winnings held in trust for horsemen, and amounts held for unclaimed ticketholder winnings.

Reporting Cash

Bank Overdrafts

When a company writes a check for more than the amount in its cash account.

- Generally **reported** as a current liability.
- Offset against cash account **only** when available cash is present in another account in the same bank on which the overdraft occurred.

Reporting Cash

Cash Equivalents

Short-term, highly liquid investments that are both

- (a) readily convertible to cash, and
- (b) so near their maturity that they present insignificant risk of changes in interest rates.

Examples: Treasury bills, Commercial paper, and Money market funds.

Receivables

Claims held against customers and others for money, goods, or services.

Oral promises of the purchaser to pay for goods and services sold.

**Accounts
Receivable**

Written promises to pay a sum of money on a specified future date.

**Notes
Receivable**

Receivables

Nontrade Receivables

Examples:

1. Advances to officers and employees.
2. Advances to subsidiaries.
3. Deposits to cover potential damages or losses.
4. Deposits as a guarantee of performance or payment.
5. Dividends and interest receivable.

Recognition of Accounts Receivables

Trade Discounts

- Reductions from the list price
- Not recognized in the accounting records
- Customers are billed net of discounts



Recognition of Accounts Receivables

Cash Discounts

- Inducements for prompt payment
- Gross Method vs. Net Method

Invoice			
SOLD		SHIP	
Payment terms are 2/10, n/30			

Recognition of Accounts Receivables

Example: On June 3, Benedict Corp. sold to Chester Inc., merchandise having a sale price of \$5,000 with terms of 2/10,n/60, f.o.b. shipping point. On June 12, Benedict received a check for the balance due from Chester. Prepare required journal entries assuming Benedict records the sale at **gross**.

Gross Method

June 3	Accounts receivable	5,000	
	Sales		5,000
June 12	Cash (\$5,000 × 98%)	4,900	
	Sales discounts	100	
	Accounts receivable		5,000

Recognition of Accounts Receivables

Example: On June 3, Benedict Corp. sold to Chester Inc., merchandise having a sale price of \$5,000 with terms of 2/10,n/60, f.o.b. shipping point. On June 12, Benedict received a check for the balance due from Chester. Prepare required journal entries assuming Benedict records the sale at **net**.

			Net Method
June 3	Accounts receivable	4,900	
	Sales		4,900
June 12	Cash	4,900	
	Accounts receivable		4,900

Recognition of Accounts Receivables

Example: On June 3, Benedict Corp. sold to Chester Inc., merchandise having a sale price of \$5,000 with terms of 2/10,n/60, f.o.b. shipping point. On **June 29**, Benedict received a check for the balance due from Chester. Prepare required journal entries assuming Benedict records the sale at **net**.

		Net Method	
June 3	Accounts receivable	4,900	
	Sales		4,900
June 29	Cash	5,000	
	Accounts receivable		4,900
	Sales discounts forfeited		100

Recognition of Accounts Receivables

Nonrecognition of Interest Element

A company should measure receivables in terms of their present value.

In practice, companies ignore interest revenue related to accounts receivable because the amount of the discount is **not usually material**.

Accounting for Accounts Receivable

How are these accounts presented on the Balance Sheet?

Accounts Receivable

Beg. 500

End. 500

Allowance for Doubtful Accounts

25 Beg.

25 End.

Assets

Current Assets:

Cash		\$ 346
Accounts receivable	500	
Less allowance for doubtful accounts	<u>25</u>	475
Inventory		812
Prepays		<u>40</u>
Total current assets		<u>1,673</u>

Fixed Assets:

Office equipment		5,679
Furniture & fixtures		6,600
Less: Accumulated depreciation		<u>(3,735)</u>
Total fixed assets		<u>8,544</u>

Total Assets		<u><u>\$10,217</u></u>
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Assets

Current Assets:

Cash	\$ 346
Accounts receivable, net of \$25 allowance for doubtful accounts	475
Inventory	812
Prepays	<u>40</u>
Total current assets	<u>1,673</u>

Fixed Assets:

Office equipment	5,679
Furniture & fixtures	6,600
Less: Accumulated depreciation	<u>(3,735)</u>
Total fixed assets	<u>8,544</u>

Total Assets	<u><u>\$10,217</u></u>
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Accounting for Accounts Receivable

Journal entry for credit sale of \$100?

Accounts receivable	100	
Sales		100

Accounts Receivable

Beg. 500

End. 500

Allowance for Doubtful Accounts

25 Beg.

25 End.

Accounting for Accounts Receivable

Journal entry for credit sale of \$100?

Accounts receivable	100	
Sales		100

Accounts Receivable

Beg.	500	
Sale	100	
End.	600	

Allowance for Doubtful Accounts

	25	Beg.
	25	End.

Accounting for Accounts Receivable

Collected of \$333 on account?

Cash	333
------	-----

Accounts receivable 333

Accounts Receivable	
Beg.	500
Sale	100
End.	600

Allowance for Doubtful Accounts	
	25 Beg.
	25 End.

Accounting for Accounts Receivable

Collected of \$333 on account?

Cash	333	
Accounts receivable		333

Accounts Receivable			Allowance for Doubtful Accounts		
Beg.	500			25	Beg.
Sale	100	333 Coll.			
End.	267			25	End.

Accounting for Accounts Receivable

Adjustment of \$15 for estimated Bad-Debts?

Bad debt expense	15	
Allowance for Doubtful Accounts		15

<u>Accounts Receivable</u>				<u>Allowance for Doubtful Accounts</u>			
Beg.	500				25		Beg.
Sale	100		333	Coll.			
<hr/>					<hr/>		
End.	267				25		End.
<hr/>					<hr/>		

Accounting for Accounts Receivable

Adjustment of \$15 for estimated Bad-Debts?

Bad debt expense	15	
Allowance for Doubtful Accounts		15

Accounts Receivable				Allowance for Doubtful Accounts			
Beg.	500				25	Beg.	
Sale	100	333	Coll.		15	Est.	
End.	267				40	End.	

Accounting for Accounts Receivable

Write-off of uncollectible accounts for \$10?

Allowance for Doubtful accounts	10	
Accounts receivable		10

<u>Accounts Receivable</u>				<u>Allowance for Doubtful Accounts</u>			
Beg.	500				25	Beg.	
Sale	100	333	Coll.		15	Est.	
<hr/>				<hr/>			
End.	267				40	End.	
<hr/>				<hr/>			

Accounting for Accounts Receivable

Write-off of uncollectible accounts for \$10?

Allowance for Doubtful accounts	10	
Accounts receivable		10

<u>Accounts Receivable</u>				<u>Allowance for Doubtful Accounts</u>			
Beg.	500				25	Beg.	
Sale	100	333	Coll.		15	Est.	
		10	W/O	W/O	10		
End.	257				30	End.	

Assets

Current Assets:

Cash	\$ 346
Accounts receivable , net of \$30 allowance for doubtful accounts	227
Inventory	812
Prepays	<u>40</u>
Total current assets	<u>1,673</u>

Fixed Assets:

Office equipment	5,679
Furniture & fixtures	6,600
Less: Accumulated depreciation	<u>(3,735)</u>
Total fixed assets	<u>8,544</u>

Total Assets	<u><u>\$10,217</u></u>
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Valuation of Accounts Receivable

Reporting Receivables

- Classification
- Valuation (net realizable value)

Uncollectible Accounts Receivable

- Sales on account raise the possibility of accounts not being collected

Uncollectible Accounts Receivable

Methods of Accounting for Uncollectible Accounts

Direct Write-Off

Theoretically undesirable:

- no matching
- receivable not stated at net realizable value

Allowance Method

Losses are Estimated:

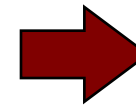
- Percentage-of-sales
- Percentage-of-receivables

Uncollectible Accounts Receivable

Percentage of Sales

Matching

Sales --- Bad Debt Expense

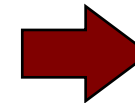


Income
Statement
Approach

Percentage of Receivables

Net Realizable Value

Receivables - Allowance for Bad Debt



Balance
Sheet
Approach

Uncollectible Accounts Receivable

Example Data

Credit sales	\$500,000
Estimated % of credit sales not collected	1.25%
Accounts receivable balance	\$72,500
Estimated % of A/R not collected	8%
Allowance for Doubtful Accounts:	
Case I	\$150 (credit balance)
Case 2	\$150 (debit balance)

Uncollectible Accounts Receivable

Percentage of Sales Method

Charge sales	\$500,000
Estimated percentage	<u>x 1.25%</u>
Estimated expense	<u>\$ 6,250</u>

=====

What should the ending balance be for the allowance account? -- **Case 1** and **Case 2**

Uncollectible Accounts Receivable

Percentage of Sales

	Case 1	Case 2
Actual balance (credit)	(150)	150
Adjustment	(6,250)	(6,250)
Ending balance	<u>(6,400)</u>	<u>(6,100)</u>

Journal entry:

Bad debt expense	6,250	
Allowance for doubtful accounts		6,250

Uncollectible Accounts Receivable

Percentage of Receivables

Accounts receivable	\$ 72,500
Estimated percentage	<u>× 8%</u>
Desired balance	<u>\$ 5,800</u>

=====

What should the ending balance be for the allowance account? -- **Case 1** and **Case 2**

Uncollectible Accounts Receivable

Percentage of Receivables

	Case 1	Case 2
Actual balance (credit)	(150)	150
Desired balance	(5,800)	(5,800)
Adjustment	(5,650)	(5,950)

Journal entry - Case 1:



Bad debt expense	5,650
Allowance for doubtful accounts	5,650

Uncollectible Accounts Receivable

Percentage of Receivables

	Case 1	Case 2
Actual balance (credit)	(150)	150
Desired balance	(5,800)	(5,800)
Adjustment	(5,650)	(5,950)

Journal entry - Case 2:

Bad debt expense	5,950
Allowance for doubtful accounts	5,950

Uncollectible Accounts Receivable

Summary

Percentage of Sales approach:

- Bad debt expense estimate is related to a nominal account (Sales), any balance in the allowance account is ignored.
- Therefore, the method achieves a proper matching of cost and revenues.

Percentage of Receivables approach:

- Results in a more accurate valuation of receivables on the balance sheet.
- Method may also be applied using an aging schedule.

Recognition of Notes Receivable

Notes Receivable

Supported by a formal promissory note.

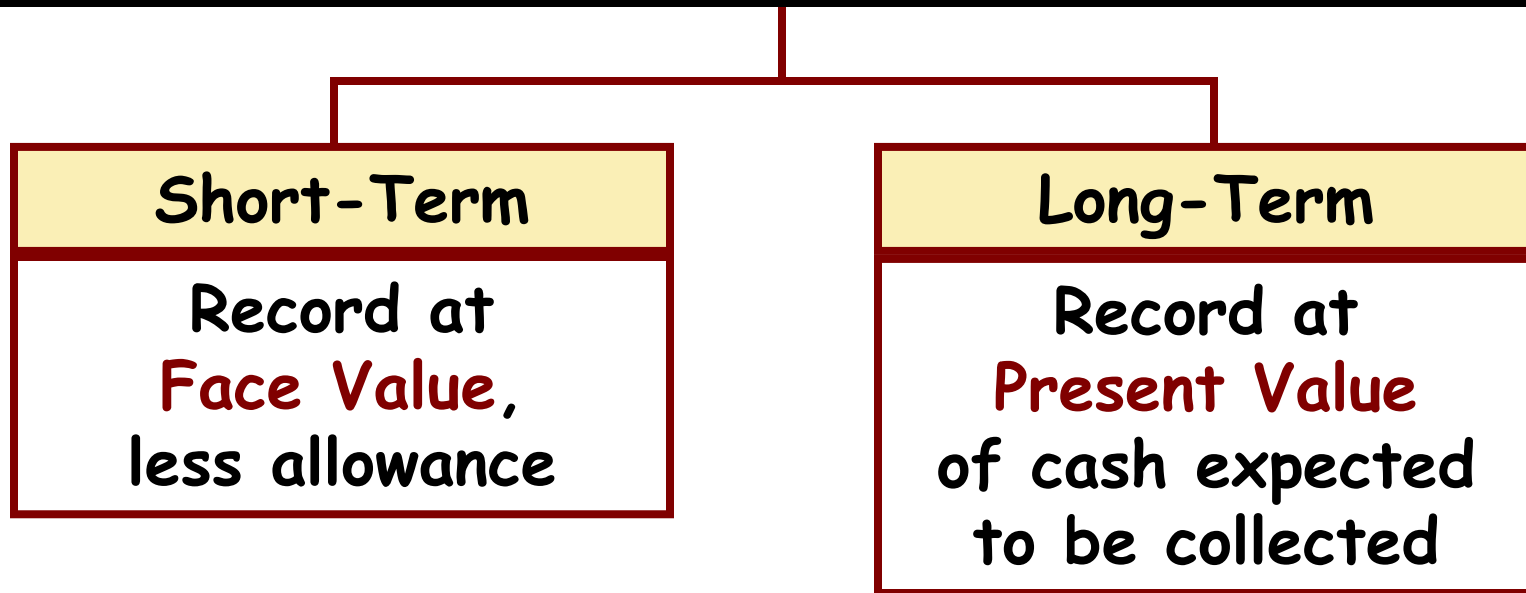
- A negotiable instrument
- Maker signs in favor of a Payee
- Interest-bearing (has a stated rate of interest) OR
- Noninterest-bearing (interest included in face amount)

Recognition of Notes Receivable

Generally originate from:

- Customers who need to extend the payment period of an outstanding receivable
- High-risk or new customers
- Loans to employees and subsidiaries
- Sales of property, plant, and equipment
- Lending transactions (the majority of notes)

Recognition of Notes Receivable



Interest Rates

Stated rate = Market rate

Stated rate > Market rate

Stated rate < Market rate

Note Issued at

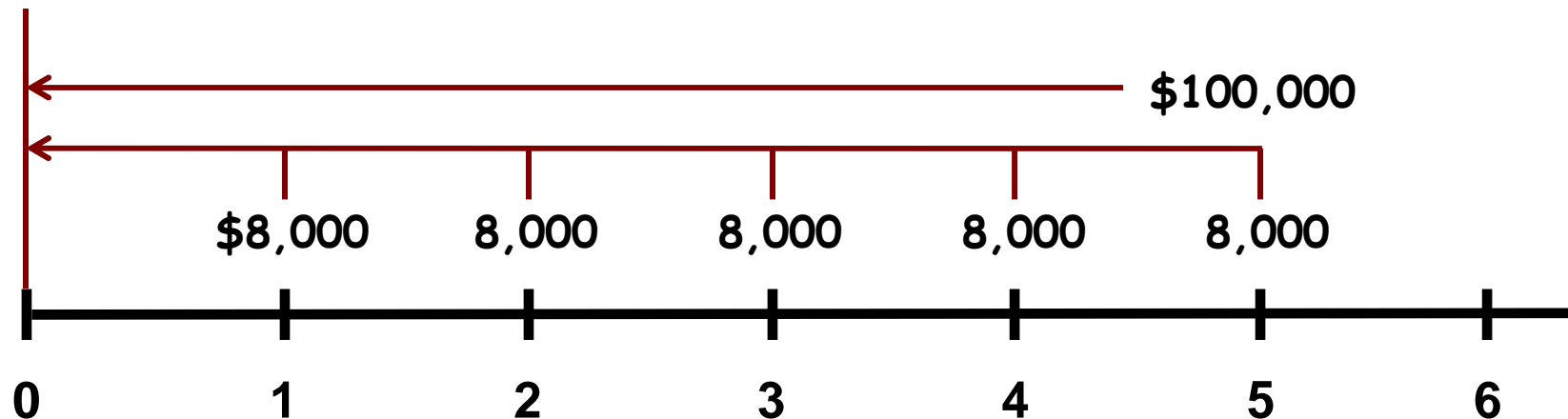
Face Value

Premium

Discount

Note Issued at Face Value

Exercise Balance Bar Co. lends Bio Foods \$100,000 in exchange for a \$100,000, 5-year note bearing interest at 8 percent annually. The market rate of interest for a note of similar risk is also 8 percent. How does Balance Bar record the receipt of the note?



Note Issued at Face Value

Table 6-4

PV of Interest

Number of Periods	Discount Rate				
	4%	6%	8%	10%	12%
1	0.96154	0.94340	0.92593	0.90900	0.89286
5	4.45183	4.21236	3.99271	3.79079	3.60478
10	8.11090	7.36009	6.71008	6.14457	5.65022
15	11.11839	9.71225	8.55948	7.60608	6.81086
20	13.59033	11.46992	9.81815	8.51356	7.46944

$$\text{\$8,000} \times 3.99271 = \text{\$31,942}$$

Interest

Factor

Present Value

Note Issued at Face Value

Table 6-2

PV of Principal

Number of Periods	Discount Rate				
	4%	6%	8%	10%	12%
1	0.96154	0.94340	0.92593	0.90909	0.89286
5	0.82193	0.74726	0.68058	0.62092	0.56743
10	0.67556	0.55839	0.46319	0.38554	0.32197
15	0.55526	0.41727	0.31524	0.23939	0.18270
20	0.45639	0.31180	0.21455	0.14864	0.10367

$$\text{\$100,000} \times .68058 = \text{\$68,058}$$

Principal

Factor

Present Value

Note Issued at Face Value

Summary	Present value of Interest	\$ 31,942
	Present value of Principal	<u>68,058</u>
	Bond current market value	<u><u>\$100,000</u></u>

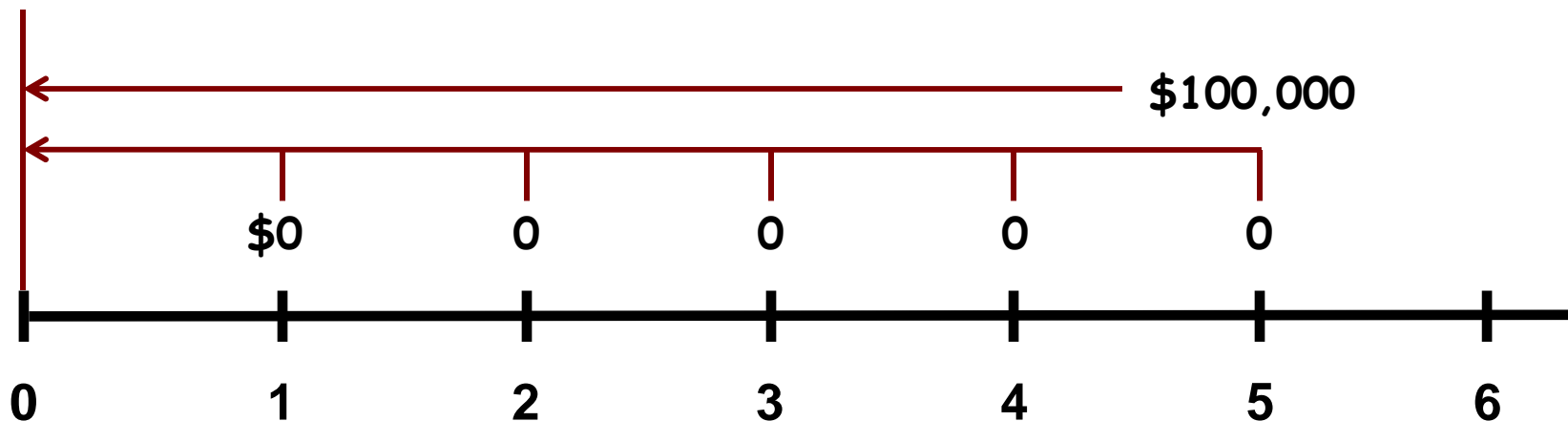
Date	Account Title	Debit	Credit
Jan. yr. 1	Notes receivable	100,000	
	Cash		100,000
Dec. yr. 1	Cash	8,000	
	Interest revenue		8,000
	(\$100,000 × 8%)		

Zero-Interest-Bearing Note

Exercise Balance Bar Co. receives a 5-year, \$100,000 zero-interest-bearing note. The market rate of interest for a note of similar risk is 6 percent. How does Balance Bar record the receipt of the note?

Present value of Principle:

$$\$100,000 (\text{PVF}_{5, 6\%}) = \$100,000 \times .74726 = \text{\textbf{\$74,726}}$$



Zero-Interest-Bearing Note

Amortization Schedule Non-Interest-Bearing Note

	Cash	6%		Carrying
	Received	Interest	Discount	Amount
		Revenue	Amortized	of Note
Date of issue				\$ 74,726
End of yr. 1	-	\$ 4,484	\$ 4,484	79,210
End of yr. 2	-	4,753	4,753	83,962
End of yr. 3	-	5,038	5,038	89,000
End of yr. 4	-	5,340	5,340	94,340
End of yr. 5	-	5,660	5,660	100,000
	-	25,274	25,274	

Zero-Interest-Bearing Note

Journal Entries for Non-Interest-Bearing note

Present value of Principal \$74,726

Date	Account Title	Debit	Credit
Jan. yr. 1	Notes receivable	100,000	
	Discount on notes receivable		25,274
	Cash		74,726
Dec. yr. 1	Discount on notes receivable	4,484	
	Interest revenue		4,484
	(\$74,726 × 6%)		

Interest-Bearing Note

Exercise Balance Bar Co. made a loan to Bio Foods and received in exchange a 5-year, \$100,000 note **bearing interest** 8 percent. The market rate of interest for a note of similar risk is 10 percent. How does Balance Bar record the receipt of the note?

Present value of Principle:

$$\$100,000 (PVF_{5, 10\%}) = \$100,000 \times .62092 = \$ 62,092$$

Present value of Interest:

$$\$8,000 (PVF_{5, 10\%}) = \$8,000 \times 3.79079 = 30,326$$

Present value of note

$$\underline{\underline{\$ 92,418}}$$

Interest-Bearing Note

Amortization Schedule Interest-Bearing Note

	Cash	10% Interest Revenue	Discount Amortized	Carrying Amount of Note
	Received			
Date of issue				\$ 92,418
End of yr. 1	8,000	\$ 9,242	\$ 1,242	93,660
End of yr. 2	8,000	9,366	1,366	95,026
End of yr. 3	8,000	9,503	1,503	96,529
End of yr. 4	8,000	9,653	1,653	98,182
End of yr. 5	8,000	9,818	1,818	100,000
	40,000	47,582	7,582	

Interest-Bearing Note

Journal Entries for Interest-Bearing Note

Date	Account Title	Debit	Credit
Jan. yr. 1	Notes receivable	100,000	
	Discount on notes receivable		7,582
	Cash		92,418
Dec. yr. 1	Cash	8,000	
	Discount on notes receivable	1,242	
	Interest revenue		9,242
	(\$92,418 × 10%)		

Valuation of Notes Receivable

- **Short-Term** reported at Net Realizable Value (same as accounting for accounts receivable).
- **Long-Term** note is impaired when collecting all amounts due (both principal and interest) will likely not occur. Accounting for impairments discussed in Appendix 14A.

Disposition of Accounts and Notes Receivable

Owner may transfer accounts or notes receivables to another company for cash.

Reasons:

- Competition.
- Sell receivables because money is tight.
- Billing / collection are time-consuming and costly.

Transfer accomplished by:

1. Secured borrowing
2. Sale of receivables

Secured Borrowing - Exercise

E7-13 On April 1, 2007, Rasheed Company assigns \$400,000 of its accounts receivable to the Third National Bank as collateral for a \$200,000 loan due July 1, 2007. The assignment agreement calls for Rasheed Company to continue to collect the receivables. Third National Bank assesses a finance charge of 2% of the accounts receivable, and interest on the loan is 10% (a realistic rate of interest for a note of this type).

Instructions

- (a) Prepare the April 1, 2007, journal entry for Rasheed Company.
- (b) Prepare the journal entry for Rasheed's collection of \$350,000 of the accounts receivable during the period from April 1, 2007, through June 30, 2007.
- (c) On July 1, 2007, Rasheed paid Third National all that was due from the loan it secured on April 1, 2004.

Secured Borrowing - Exercise

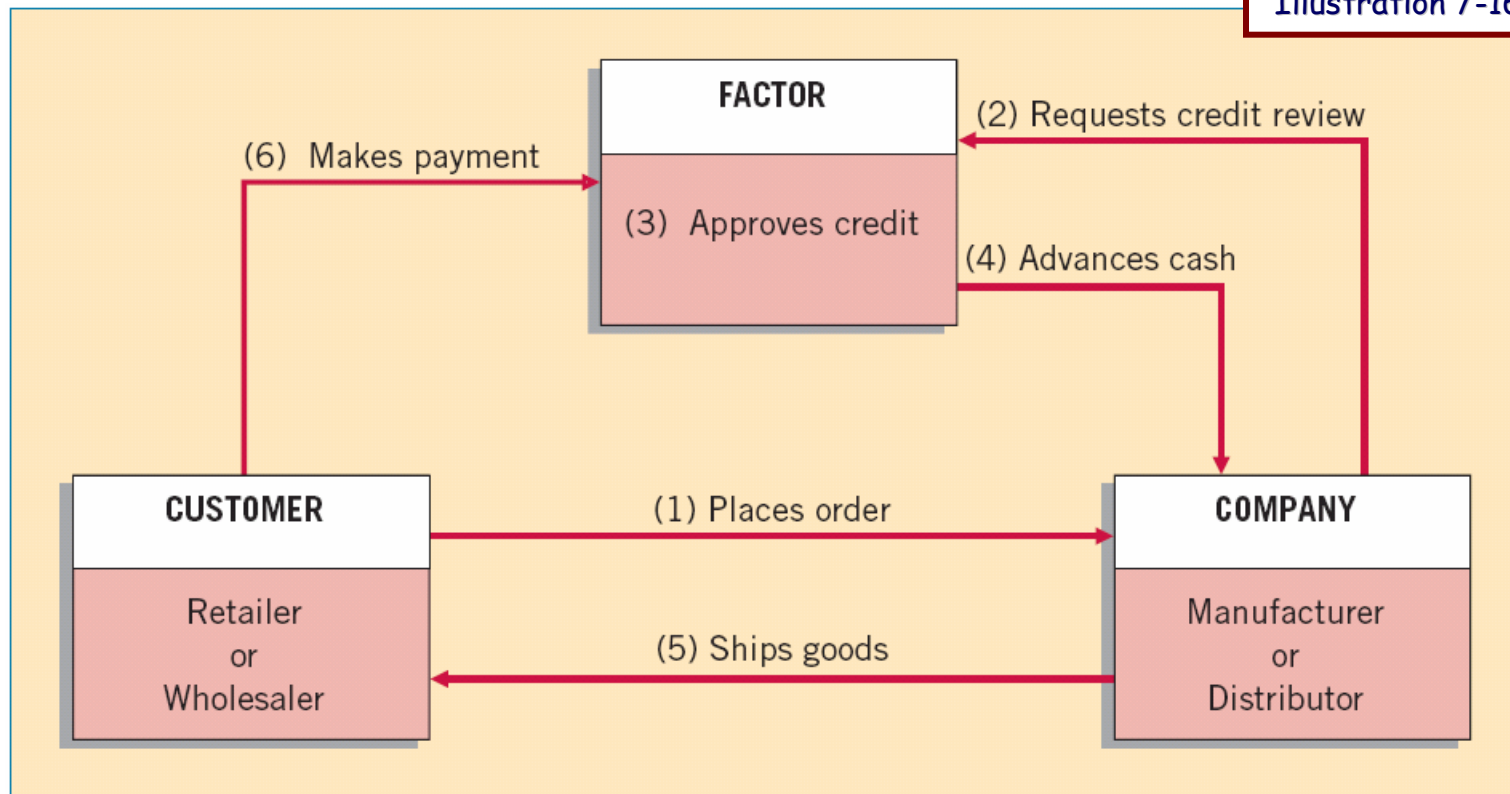
Exercise 7-13 continued

Date	Account Title	Debit	Credit
(a)	Cash	192,000	
	Finance Charge	8,000	
	Notes Payable		200,000
	(\$400,000 × 2% = \$8,000)		
(b)	Cash	350,000	
	Accounts Receivable		350,000
(c)	Notes Payable	200,000	
	Interest Expense	5,000	
	Cash		205,000
	(10% × \$200,000 × 3/12 = \$5,000)		

Sales of Receivables

Factors are finance companies or banks that buy receivables from businesses for a fee.

Illustration 7-16



Sales of Receivables

Sale Without Recourse

- Purchaser assumes risk of collection
- Transfer is outright sale of receivable
- Seller records loss on sale
- Seller use Due from Factor (receivable) account to cover discounts, returns, and allowances

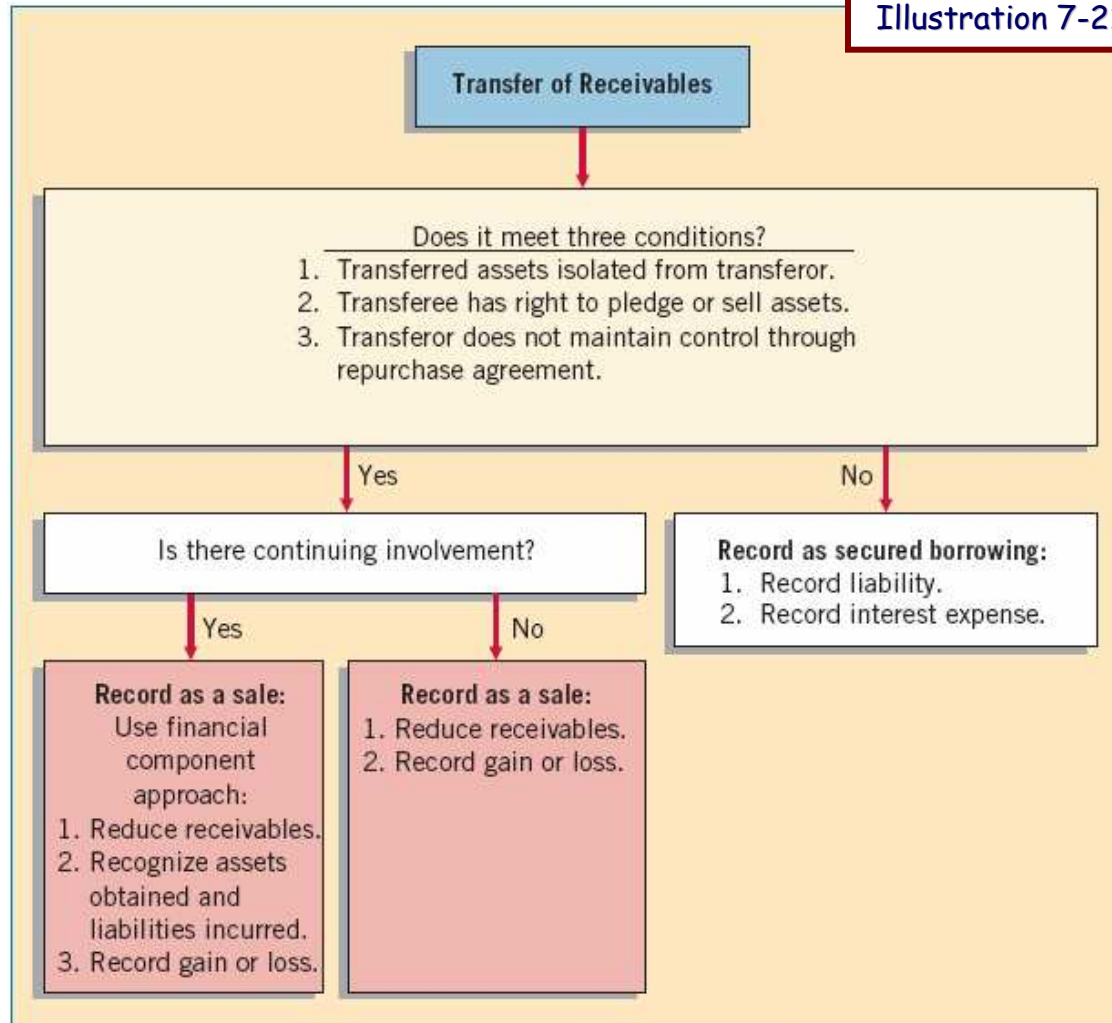
Sale With Recourse

- Seller guarantees payment to purchaser
- Financial components approach used to record transfer

Secured Borrowing versus Sale

The **FASB** concluded that a sale occurs only if the seller surrenders control of the receivables to the buyer. **Three conditions** must be met:

Illustration 7-21



Presentation and Analysis

General rule in classifying receivables are:

1. Segregate the different types of receivables that a company possesses, if material.
2. Appropriately offset the valuation accounts against the proper receivable accounts.
3. Determine that receivables classified in the current assets section will be converted into cash within the year or the operating cycle, whichever is longer.
4. Disclose any loss contingencies that exist on the receivables.
5. Disclose any receivables designated or pledged as collateral.
6. Disclose all significant concentrations of credit risk arising from receivables.

Presentation and Analysis

Analysis of Receivables

Illustration 7-23

$$\frac{\text{Net Sales}}{\text{Average Trade Receivables (net)}} = \text{Accounts Receivable Turnover}$$
$$\frac{\$9,745}{(\$580 + \$380)/2} = 20.3 \text{ times, or every 18 days}$$
$$(365 \div 20.3)$$

This Ratio used to:

- Assess the liquidity of the receivables.
- Measure the number of times, on average, a company collects receivables during the period.

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