

CHAPTER FOUR

CASH AND RECEIVABLES

CASH

What is Cash?

A **financial asset**—also a **financial instrument**.

Financial Instrument - Any contract that gives rise to a financial asset of one entity and a financial liability or equity interest of another entity.

<u>Financial Assets</u>	<u>Non-Financial Assets</u>
Cash	Inventory
Loans and receivables	Prepaid expenses
Investments in debt securities	Property, plant, and equipment
Investments in equity securities	Intangible assets

CASH

What is Cash?

- ◆ Most liquid asset.
- ◆ Standard medium of exchange.
- ◆ Basis for measuring and accounting for all other 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.

CASH

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 value.

Examples: Treasury bills, commercial paper, and money market funds.

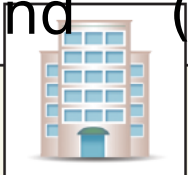
Reporting Cash

Restricted Cash

Companies segregate **restricted cash** from “regular” cash.

Examples, restricted for:

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



Infosys

Restricted Deposits (000,000). Deposits with financial institutions as at March 31, 2013 include ₹7,980 (₹5,500 as at March 31, 2012) deposited with Life Insurance Corporation of India to settle employee-related obligations as and when they arise during the normal course of business. This amount is considered as restricted cash and hence not considered “cash and cash equivalents.”

Reporting Cash

Bank Overdrafts

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

- ◆ Generally reported as a **current liability**.
- ◆ **Offset** against other cash accounts **only** when accounts are with the same bank.

Summary of Cash-Related Items

ILLUSTRATION 7-3

Classification of Cash, Cash Equivalents, and Non-Cash Items		
Item	Classification	Comment
Cash	Cash	If unrestricted, report as cash. If restricted, identify and classify as current and noncurrent assets.
Petty cash and change funds	Cash	Report as cash.
Short-term paper	Cash equivalents	Investments with maturity of less than 3 months, often combined with cash.
Short-term paper	Short-term investments	Investments with maturity of 3 to 12 months.
Postdated checks and I.O.U.s	Receivables	Assumed to be collectible.
Travel advances	Receivables	Assumed to be collected from employees or deducted from their salaries.
Postage on hand (as stamps or in postage meters)	Prepaid expenses	May also be classified as office supplies inventory.
Bank overdrafts	Cash	If no offsetting allowed, current liability.
Compensating balances	Cash separately classified as a deposit maintained as compensating balance	Classify as current or non-current in the statement of financial position. Disclose separately in notes details of the arrangement.

ACCOUNTS RECEIVABLE

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 certain sum of money on a specified future date.

**Notes
Receivable**

ACCOUNTS RECEIVABLE

Non-Trade Receivables

1. Advances to officers and employees.
2. Advances to subsidiaries.
3. Deposits paid to cover potential damages or losses.
4. Deposits paid as a guarantee of performance or payment.
5. Dividends and interest receivable.
6. Claims against: Insurance companies for casualties sustained; defendants under suit; governmental bodies for tax refunds; common carriers for damaged or lost goods; creditors for returned, damaged, or lost goods; customers for returnable items (crates, containers, etc.).

Non-Trade Receivables

ILLUSTRATION 7-4

Receivables
Statement of
Financial Position
Sheet Presentations

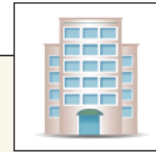


Heineken

(in millions of €)

Current assets

Inventories	1,596
Other investments	11
Trade and other receivables	2,537
Prepayments and accrued income	232
Cash and cash equivalents	1,037
Assets classified as held for sale	124
Total current assets	<u>5,537</u>



Nokia

(in millions of €)

Current assets

Inventories	984
Accounts receivable, net of allowances for doubtful accounts	4,111
Prepaid expenses and accrued income	879
Current portion of long-term loans receivable.	37
Other financial assets	167
Cash and cash equivalents	2,418
	<u>8,596</u>

Recognition of Accounts Receivable

Trade Discounts

Use to:

- ◆ Avoid frequent changes in catalogs.
- ◆ Alter prices for different quantities purchased.
- ◆ Hide the true invoice price from competitors.



Recognition of Accounts Receivable

Cash Discounts (Sales Discounts)

- ◆ Offered to induce prompt payment.
- ◆ Terms such as 2/10, n/30, 2/10, E.O.M., or net 30, E.O.M.
- ◆ Gross Method vs. Net Method.

The illustration shows a rectangular invoice form. At the top left, the word "Invoice" is printed. To its right is a small table with two rows and two columns. Below "Invoice", the word "SOLD" is printed vertically next to a rectangular box, and the word "SHIP" is printed vertically next to another rectangular box. In the center of the invoice, there is a large rectangular area with a grid of lines. Overlaid on this area is a white callout box with a grey shadowed corner. Inside the callout, the text "Payment terms are 2/10, n/30" is written in a bold, sans-serif font.

Cash Discounts (Sales Discounts)

ILLUSTRATION 7-5

Entries under
Gross
and Net Methods

<u>Gross Method</u>		<u>Net Method</u>	
Sales of \$10,000, terms 2/10, n/30			
	Accounts Receivable	9,800	
	Sales Revenue		9,800
Payment on \$4,000 of sales received within discount period			
	Cash	3,920	
	Accounts Receivable		3,920
Payment on \$6,000 of sales received after discount period			
	Accounts Receivable	120	
	Sales Discounts		
	Forfeited ($\$6,000 \times .02$)		120
	Cash	6,000	
	Accounts Receivable		6,000

Recognition of Accounts Receivable

Illustration: On June 3, Bolton Company sold to Arquette Company merchandise having a sale price of £2,000 with terms of 2/10, n/60. On June 12, the company received a check for the balance due from Arquette Company. Prepare the journal entries on Bolton Company books to record the sale assuming Bolton records sales using the **gross method**.

June 3	Accounts Receivable	2,000
	Sales Revenue	
June 12	Cash (2,000 x 98%)	1,960
	Sales Discounts	40
	Accounts Receivable	
		2,000

Recognition of Accounts Receivable

Illustration: On June 3, Bolton Company sold to Arquette Company merchandise having a sale price of £2,000 with terms of 2/10, n/60. On June 12, the company received a check for the balance due from Arquette Company. Prepare the journal entries on Bolton Company books to record the sale assuming Bolton records sales using the **net method**.

June 3	Accounts Receivable	1,960
	Sales Revenue	
June 12	Cash (1,960,000 x 98%)	1,960
	Accounts Receivable	1,960

Recognition of Accounts Receivable

Illustration: On June 3, Bolton Company sold to Arquette Company merchandise having a sale price of £2,000 with terms of 2/10, n/60, f.o.b. shipping point. Prepare the journal entries on Bolton Company books to record the sale assuming Bolton records sales using the **net method**, and **Arquette did not remit payment until July 29.**

June 3	Accounts Receivable	1,960
	Sales Revenue	

June 12	Cash	1,960	2,000
	Accounts Receivable		
	1,960		
	Sales Discounts Forfeited		40

Recognition of Accounts Receivable

Non-Recognition 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, for current assets, the amount of the discount is not usually material in relation to the net income for the period.



Underlying Concepts

Materiality means it must make a difference to a decision-maker. The IASB believes that present value concepts can be ignored for short-term receivables. That is, the present value effects are not material.

ACCOUNTS RECEIVABLE

How are these accounts presented on the Statement of Financial Position?

Accounts Receivable	
Beg.	
500	
End.	
500	

Allowance for Doubtful Accounts	
	25
	Beg.
	25
	End.

ACCOUNTS RECEIVABLE

ABC Corporation
Statement of Financial Position (partial)

Current Assets:

Inventory		\$	812
Prepaid expense			40
Accounts receivable	500		
Less: Allowance for doubtful accounts	(25)		475
Cash			330
Total current assets			1,657

ACCOUNTS RECEIVABLE

ABC Corporation
Statement of Financial Position (partial)

Current Assets:

Inventory	\$ 812
Prepaid expense	40
Accounts receivable, net of \$25 allowance	475
Cash	330
Total current assets	<u>1,657</u>

ACCOUNTS RECEIVABLE

Journal entry for credit sale of \$100?

Accounts Receivable	100	
Sales Revenue		100

Accounts Receivable	
Beg.	
500	
End.	
500	

Allowance for Doubtful Accounts	
	25
	Beg.
	End.
	25

ACCOUNTS RECEIVABLE

Journal entry for credit sale of \$100?

Accounts Receivable	100	
Sales Revenue		100

Accounts Receivable	
Beg. 500	
Sale 100	
End. 600	

Allowance for Doubtful Accounts	
	25 Beg.
	25 End.

ACCOUNTS RECEIVABLE

Collected \$333 on account?

Cash 333

Accounts Receivable

333

Accounts Receivable	
Beg.	
500	
Sale	
100	
End.	
600	

Allowance for Doubtful Accounts	
	25
	Beg.
	25
	End.

ACCOUNTS RECEIVABLE

Collected \$333 on account?

Cash 333

Accounts Receivable

333

Accounts Receivable	
Beg.	
500	
Sale	333
100	Coll.
End.	
267	

Allowance for Doubtful Accounts	
	25
	Beg.
	25
	End.

ACCOUNTS RECEIVABLE

Adjustment of \$15 for estimated bad debts?

Bad Debt Expense 15

Allowance for Doubtful Accounts	15
---------------------------------	----

Accounts Receivable	
Beg. 500	
Sale 100	333
	Coll.
End. 267	

Allowance for Doubtful Accounts	
	25
	Beg.
	25
	End.

ACCOUNTS RECEIVABLE

Adjustment of \$15 for estimated bad debts?

Bad Debt Expense 15

Allowance for Doubtful Accounts	15
---------------------------------	----

Accounts Receivable	
Beg. 500	
Sale 100	333
	Coll.
End. 267	

Allowance for Doubtful Accounts	
	25 Beg.
	15 Est.
	40
	End.

ACCOUNTS RECEIVABLE

Write-off of uncollectible accounts for \$10?

Allowance for Doubtful accounts 10

Accounts Receivable 10

Accounts Receivable	
Beg. 500	
Sale 100	333
	Coll.
End. 267	

Allowance for Doubtful Accounts	
	25
	Beg.
	15
	Est.
	40
	End.

ACCOUNTS RECEIVABLE

Write-off of uncollectible accounts for \$10?

Allowance for Doubtful accounts 10

Accounts Receivable 10

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

ACCOUNTS RECEIVABLE

ABC Corporation
Statement of Financial Position (partial)

Current Assets:

Inventory	\$ 812
Prepaid expense	40
Accounts receivable, net of \$30 allowance	227
Cash	330
Total current assets	<u>1,409</u>

ACCOUNTS RECEIVABLE

Valuation of Accounts Receivable

- ◆ Reporting of receivables involves
 - 1) classification and
 - 2) valuation on the statement of financial position.
- ◆ Classification involves determining the length of time each receivable will be outstanding.
- ◆ Value and report short-term receivables at **cash realizable value**.

Valuation of Accounts Receivable

Uncollectible Accounts Receivable

- ◆ Record credit losses as debits to Bad Debt Expense (or Uncollectible Accounts Expense).
- ◆ Normal and necessary risk of doing business on credit.
- ◆ Two methods to account for uncollectible accounts:
 - 1) Direct write-off method
 - 2) Allowance method

Valuation of Accounts Receivable

Methods of Accounting for Uncollectible Accounts

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graph TD; A[Methods of Accounting for Uncollectible Accounts] --> B[Direct Write-Off]; A --> C[Allowance Method];
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Direct Write-Off

Theoretically deficient:

- ◆ No matching.
- ◆ Receivable not stated at cash realizable value.
- ◆ Not appropriate when amount uncollectible is material.

Allowance Method

Losses are estimated:

- ◆ Percentage-of-sales.
- ◆ Percentage-of-receivables.
- ◆ IFRS requires when bad debts are material in amount.

Allowance Method

ILLUSTRATION 7-7

Comparison of Bases for
Estimating
Uncollectibles

Percentage of Sales

Sales $\longleftrightarrow$ Bad Debt Expense

Emphasis on Income Statement Relationships

The **percentage-of-sales basis** results in a better matching of expenses with revenues

Percentage of Receivables

Accounts Receivable $\longleftrightarrow$ Allowance for Doubtful Accounts

Emphasis on Statement of Financial Position Relationships

The **percentage-of-receivables basis** produces the better estimate of cash realizable value

Allowance Method

Percentage-of-Sales Approach

- ◆ Percentage based upon past experience and anticipate credit policy.
- ◆ Achieves better matching of cost and revenues.
- ◆ Any balance in Allowance for Doubtful Accounts is ignored.
- ◆ Method frequently referred to as the **income statement approach**.

Percentage-of-Sales Approach

Illustration: Gonzalez Company estimates that about 1% of net credit sales will become uncollectible. If net credit sales are R\$800,000 for the year, it records bad debt expense as follows.

Bad Debt Expense (1% x R\$800,000) 8,000

Allowance for Doubtful Accounts 8,000

ILLUSTRATION

Bad Debt Expense		Allowance for Doubtful Accounts	
Dec. 31 Adj.	8,000	Jan. 1 Bal.	1,723
		Dec. 31 Adj.	8,000
		Dec. 31 Bal.	9,723

Allowance Method

Percentage-of-Receivables Approach

- ◆ Not matching.
- ◆ Estimate of the receivables' realizable value.

Companies may apply this method using

- ◆ one **composite rate**, or
- ◆ an **aging schedule** using different rates.

Percentage-of-Receivables Approach

WILSON & CO. AGING SCHEDULE

Name of Customer	Balance Dec. 31	Under 60 days	60–90 days	91–120 days	Over 120 days
Western Stainless Steel Corp.	€ 98,000	€ 80,000	€18,000		
Brockway Steel Company	320,000	320,000			
Freeport Sheet & Tube Co.	55,000				€55,000
Allegheny Iron Works	74,000	60,000		€14,000	
	<u>€547,000</u>	<u>€460,000</u>	<u>€18,000</u>	<u>€14,000</u>	<u>€55,000</u>

Summary

Age	Amount	Percentage Estimated to Be Uncollectible	Required Balance in Allowance
Under 60 days old	€460,000	4%	€18,400
60–90 days old	18,000	15%	2,700
91–120 days old	14,000	20%	2,800
Over 120 days	55,000	25%	13,750
Year-end balance of allowance for doubtful accounts			<u>€37,650</u>

ILLUSTRATION 7-9 Accounts Receivable Aging Schedule

What entry
would Wilson
make
assuming that
the allowance
account had a
**zero
balance?**

Bad Debt Expense 37,650

Allowance for Doubtful Accounts 37,650

Percentage-of-Receivables Approach

WILSON & CO. AGING SCHEDULE

Name of Customer	Balance Dec. 31	Under 60 days	60–90 days	91–120 days	Over 120 days
Western Stainless Steel Corp.	€ 98,000	€ 80,000	€18,000		
Brockway Steel Company	320,000	320,000			
Freeport Sheet & Tube Co.	55,000				€55,000
Allegheny Iron Works	74,000	60,000		€14,000	
	<u>€547,000</u>	<u>€460,000</u>	<u>€18,000</u>	<u>€14,000</u>	<u>€55,000</u>

Summary

Age	Amount	Percentage Estimated to Be Uncollectible	Required Balance in Allowance
Under 60 days old	€460,000	4%	€18,400
60–90 days old	18,000	15%	2,700
91–120 days old	14,000	20%	2,800
Over 120 days	55,000	25%	13,750
Year-end balance of allowance for doubtful accounts			<u>€37,650</u>

ILLUSTRATION 7-9 Accounts Receivable Aging Schedule

What entry would Wilson make assuming the allowance account had a **credit balance of €800** before adjustment?

Bad Debt Expense (€37,650 - €800) 36,850

Allowance for Doubtful Accounts 36,850

Allowance Method

Illustration: Sandel Company reports the following financial information before adjustments.

	Dr.	Cr.
Accounts Receivable	€160,000	
Allowance for Doubtful Accounts		€ 2,000
Sales Revenue (all on credit)		800,000
Sales Returns and Allowances	50,000	

Instructions: Prepare the journal entry to record bad debt expense assuming Sandel Company estimates bad debts at (a) 1% of net sales and (b) 5% of accounts receivable.

Allowance Method

Illustration: Sandel Company reports the following financial information before adjustments.

	<u>Dr.</u>	<u>Cr.</u>
Accounts Receivable	€160,000	
Allowance for Doubtful Accounts		€ 2,000
Sales Revenue (all on credit)		800,000
Sales Returns and Allowances	50,000	

Instructions: Prepare the journal entry assuming Sandel estimates bad debts at (b) **1% of net sales**.

Bad Debt Expense	7,500	
Allowance for Doubtful Accounts		7,500
$(€800,000 - €50,000) \times 1\% = €7,500$		

Allowance Method

Illustration: Sandel Company reports the following financial information before adjustments.

	<u>Dr.</u>	<u>Cr.</u>
Accounts Receivable	€160,000	
Allowance for Doubtful Accounts		€ 2,000
Sales Revenue (all on credit)		800,000
Sales Returns and Allowances	50,000	

Instructions: Prepare the journal entry assuming Sandel estimates bad debts at (b) **5% of accounts receivable.**

Bad Debt Expense	6,000	
Allowance for Doubtful Accounts		6,000
$(€160,000 \times 5\%) - €2,000 = €6,000$		

~~Write-Off of Uncollectible~~ ~~Accounts~~

Illustration: The financial vice president of Brown Furniture authorizes a write-off of the £1,000 balance owed by Randall Co. on March 1. The entry to record the write-off is:

Allowance for Doubtful Accounts	1,000
Accounts Receivable	1,000

Assume that on July 1, Randall Co. pays the £1,000 amount that Brown had written off on March 1. These are the entries:

Accounts Receivable	1,000	
Allowance for Doubtful Accounts		1,000
Cash	1,000	
Accounts Receivable	1,000	

Impairment Evaluation Process

Companies assess their receivables for impairment each reporting period. Possible loss events are:

1. Significant financial problems of the customer.
2. Payment defaults.
3. Renegotiation of terms of the receivable due to financial difficulty of the customer.
4. Decrease in estimated future cash flows from a group of receivables since initial recognition, although the decrease cannot yet be identified with individual assets in the group.

Impairment Evaluation Process

A receivable is considered impaired when a loss event indicates a negative impact on the estimated future cash flows to be received from the customer. The IASB requires that the impairment assessment should be performed as follows.

1. Receivables that are individually significant should be considered for impairment separately.
2. Any receivable individually assessed that is not considered impaired should be included with a group of assets with similar credit-risk characteristics and collectively assessed for impairment.
3. Any receivables not **individually assessed** should be **collectively assessed** for impairment.

Impairment Evaluation Process

Illustration: Hector Company has the following receivables classified into individually significant and all other receivables.

Individually significant receivables		
Yaan Company	€ 40,000	
Randon Inc.	100,000	
Fernando Co.	60,000	
Blanchard Ltd.	<u>50,000</u>	€250,000
All other receivables		<u>500,000</u>
Total		<u><u>€750,000</u></u>

Hector determines that Yaan's receivable is impaired by €15,000, and Blanchard's receivable is totally impaired. Both Randon's and Fernando's receivables are not considered impaired. Hector also determines that a composite rate of 2% is appropriate to measure impairment on all other receivables.

Impairment Evaluation Process

The total impairment is computed as follows.

ILLUSTRATION 7-10

Accounts Receivable Impairments

Individually assessed receivables

Yaan Company	€15,000
Blanchard Ltd.	50,000

Collectively assessed receivables

Add: Randon Inc.	€500,000
	100,000
Fernando Co.	60,000

Total collectively assessed receivables

€660,000

Collectively assessed impairments ($€660,000 \times 2\%$)

13,200

Total impairment

€78,200

NOTES RECEIVABLE

Supported by a formal **promissory note**.

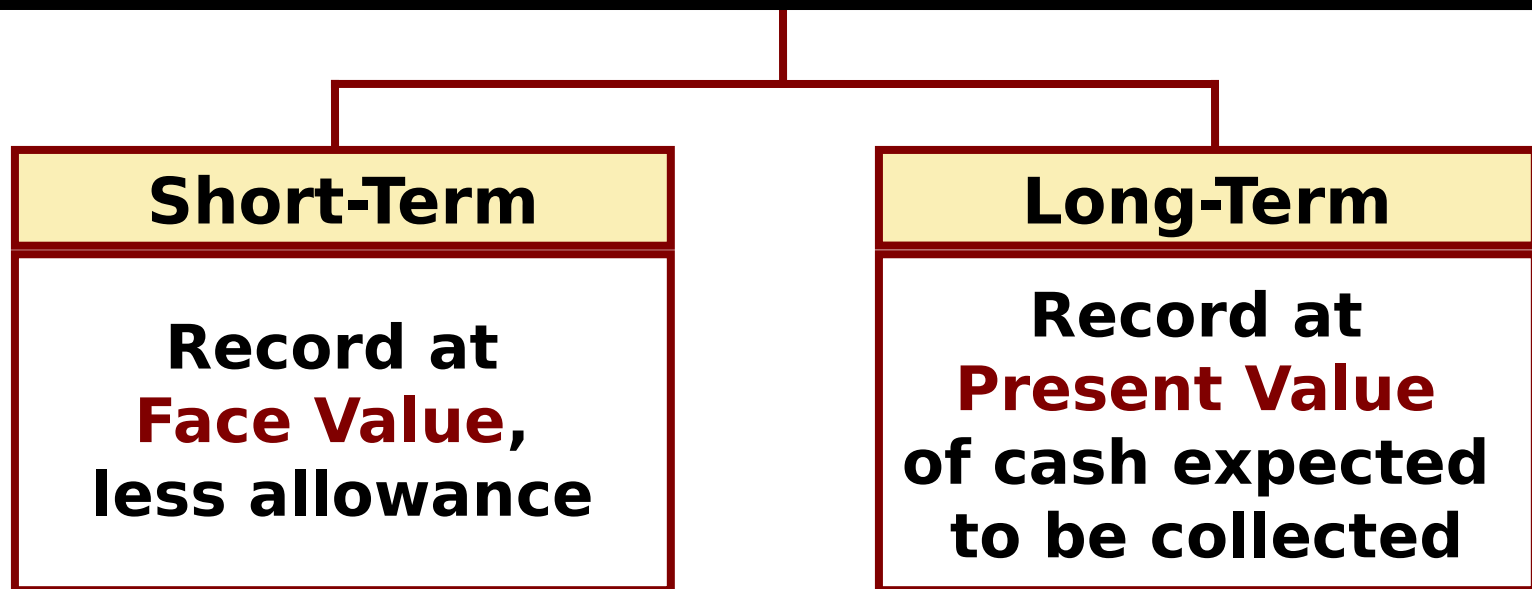
- ◆ A negotiable instrument.
- ◆ Maker signs in favor of a Payee.
- ◆ Interest-bearing (has a stated rate of interest)
OR
- ◆ Zero-interest-bearing (interest included in face amount).

NOTES RECEIVABLE

Generally originate from:

- ◆ Customers who need to extend 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

Illustration: Bigelow Corp. lends Scandinavian Imports €10,000 in exchange for a €10,000, three-year note bearing interest at 10 percent annually. The market rate of interest for a note of similar risk is also 10 percent. How does Bigelow record the receipt of the note?

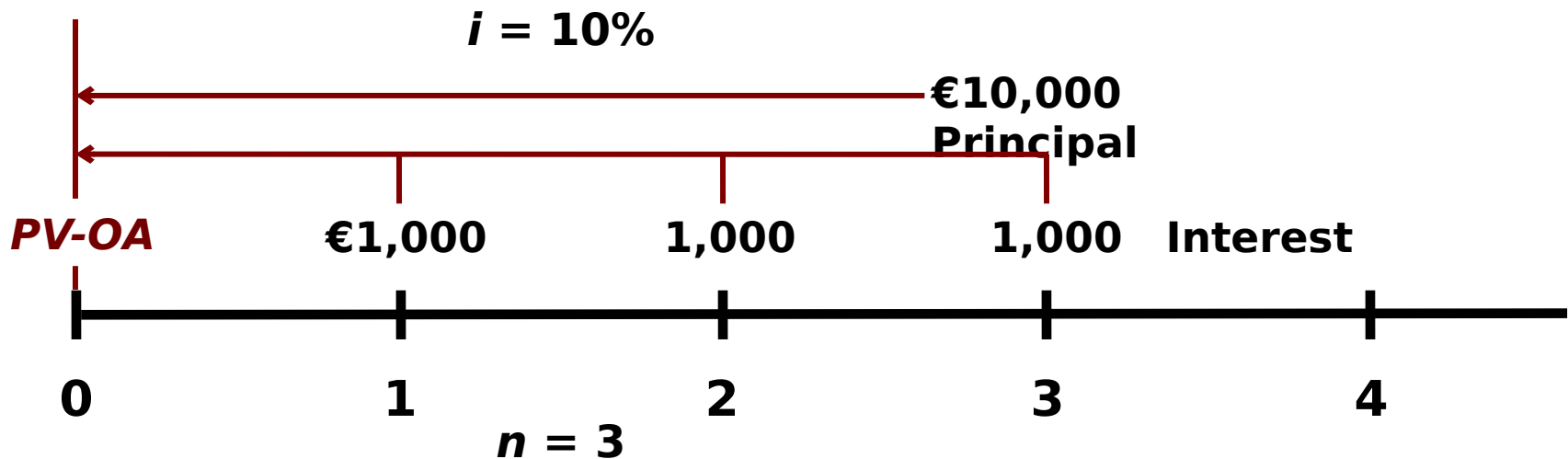


ILLUSTRATION 7-11

Time Diagram for Note Issued at Face Value

Note Issued at Face Value

PV of Interest

TABLE 6-4 PRESENT VALUE OF AN ORDINARY ANNUITY OF 1

8%	9%	10%	11%	12%	15%	(n) Periods
.92593	.91743	.90909	.90090	.89286	.86957	1
1.78326	1.75911	1.73554	1.71252	1.69005	1.62571	2
2.57710	2.53130	2.48685	2.44371	2.40183	2.28323	3
3.31213	3.23972	3.16986	3.10245	3.03735	2.85498	4
3.99271	3.88965	3.79079	3.69590	3.60478	3.35216	5
4.62288	4.48592	4.35526	4.23054	4.11141	3.78448	6
5.20637	5.03295	4.86842	4.71220	4.56376	4.16042	7
5.74664	5.53482	5.33493	5.14612	4.96764	4.48732	8
6.24689	5.99525	5.75902	5.53705	5.32825	4.77158	9
6.71008	6.41766	6.14457	5.88923	5.65022	5.01877	10

$$\begin{array}{ccccc}
 \text{€1,000} & \times & 2.48685 & = & \text{€2,487} \\
 \text{Interest} & & \text{Factor} & & \text{Present} \\
 \text{Received} & & & & \text{Value}
 \end{array}$$

Note Issued at Face Value

PV of Principal

TABLE 6-2 PRESENT VALUE OF 1

8%	9%	10%	11%	12%	15%	(n) Periods
.92593	.91743	.90909	.90090	.89286	.86957	1
.85734	.84168	.82645	.81162	.79719	.75614	2
.79383	.77218	.75132	.73119	.71178	.65752	3
.73503	.70843	.68301	.65873	.63552	.57175	4
.68058	.64993	.62092	.59345	.56743	.49718	5
.63017	.59627	.56447	.53464	.50663	.43233	6
.58349	.54703	.51316	.48166	.45235	.37594	7
.54027	.50187	.46651	.43393	.40388	.32690	8
.50025	.46043	.42410	.39092	.36061	.28426	9
.46319	.42241	.38554	.35218	.32197	.24719	10

$$\begin{array}{ccccccc}
 \text{€10,000} & \times & .75132 & = & \text{€7,513} \\
 \text{Principal} & & \text{Factor} & & \text{Present Value}
 \end{array}$$

Note Issued at Face Value

Summary	Present value of interest	€ 2,487
	Present value of principal	<u>7,513</u>
	Note current market value	<u>~~€10,000~~</u>

Journal Entries

Jan. yr. 1	Notes Receivable	10,000
	Cash	10,000
Dec. yr. 1	Cash	1,000
	Interest Revenue	1,000

Zero-Interest-Bearing Notes

Illustration: Jeremiah Company receives a three-year, \$10,000 **zero-interest-bearing** note. The market rate of interest for a note of similar risk is 9 percent. How does Jeremiah record the receipt of the note?

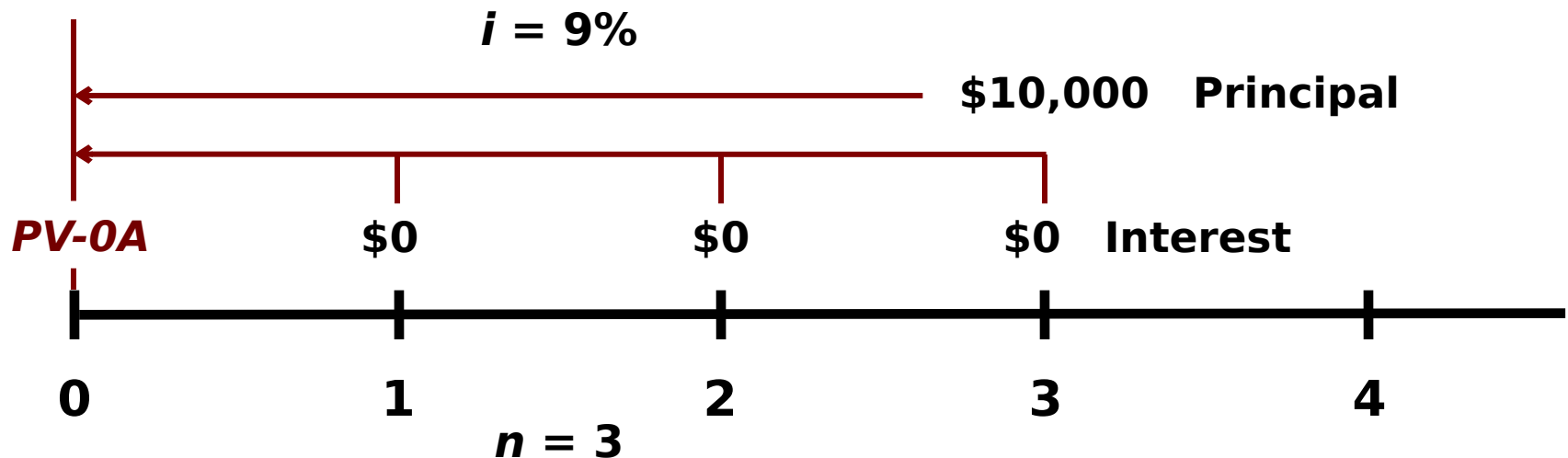


ILLUSTRATION 7-13

Time Diagram for
Zero-Interest-Bearing
Note

Zero-Interest-Bearing Notes

PV of Principal

TABLE 6-2 PRESENT VALUE OF 1

8%	9%	10%	11%	12%	15%	(n) Periods
.92593	.91743	.90909	.90090	.89286	.86957	1
.85734	.84168	.82645	.81162	.79719	.75614	2
.79383	.77218	.75132	.73119	.71178	.65752	3
.73503	.70843	.68301	.65873	.63552	.57175	4
.68058	.64993	.62092	.59345	.56743	.49718	5
.63017	.59627	.56447	.53464	.50663	.43233	6
.58349	.54703	.51316	.48166	.45235	.37594	7
.54027	.50187	.46651	.43393	.40388	.32690	8
.50025	.46043	.42410	.39092	.36061	.28426	9
.46319	.42241	.38554	.35218	.32197	.24719	10

$$\begin{array}{ccccccc}
 \text{\$10,000} & \times & .77218 & = & \text{\$7,721.80} \\
 \text{Principal} & & \text{Factor} & & \text{Present Value}
 \end{array}$$

Zero-Interest-Bearing Notes

SCHEDULE OF NOTE DISCOUNT AMORTIZATION EFFECTIVE-INTEREST METHOD 0% NOTE DISCOUNTED AT 9%

	<u>Cash Received</u>	<u>Interest Revenue</u>	<u>Discount Amortized</u>	<u>Carrying Amount of Note</u>
Date of issue				\$ 7,721.80
End of year 1	\$ -0-	\$ 694.96 ^a	\$ 694.96 ^b	8,416.76 ^c
End of year 2	-0-	757.51	757.51	9,174.27
End of year 3	-0-	825.73 ^d	825.73	10,000.00
	<u>\$ -0-</u>	<u>\$2,278.20</u>	<u>\$2,278.20</u>	

^a $\$7,721.80 \times .09 = \$694.96$
^c $\$7,721.80 + \$694.96 = \$8,416.76$
^b $\$694.96 - 0 = \$694.96$
^d5¢ adjustment to compensate for rounding

ILLUSTRATION 7-14

Discount Amortization Schedule
—Effective-Interest Method

Zero-Interest-Bearing Notes

ILLUSTRATION 7-14

Discount
Amortization
Schedule—
Effective-Interest
Method

SCHEDULE OF NOTE DISCOUNT AMORTIZATION EFFECTIVE-INTEREST METHOD 0% NOTE DISCOUNTED AT 9%

	Cash Received	Interest Revenue	Discount Amortized	Carrying Amount of Note
Date of issue				\$ 7,721.80
End of year 1	\$ -0-	\$ 694.96 ^a	\$ 694.96 ^b	8,416.76 ^c
End of year 2	-0-	757.51	757.51	9,174.27
End of year 3	-0-	825.73 ^d	825.73	10,000.00
	<u>\$ -0-</u>	<u>\$2,278.20</u>	<u>\$2,278.20</u>	



Prepare the journal entry to record the receipt of the note.

Notes Receivable

7,721.80

Cash

7,721.80

Zero-Interest-Bearing Notes

ILLUSTRATION 7-14

Discount
Amortization
Schedule—
Effective-Interest
Method

SCHEDULE OF NOTE DISCOUNT AMORTIZATION EFFECTIVE-INTEREST METHOD 0% NOTE DISCOUNTED AT 9%

	<u>Cash Received</u>	<u>Interest Revenue</u>	<u>Discount Amortized</u>	<u>Carrying Amount of Note</u>
Date of issue				\$ 7,721.80
End of year 1	\$ -0-	 \$ 694.96 ^a	\$ 694.96 ^b	8,416.76 ^c
End of year 2	-0-	757.51	757.51	9,174.27
End of year 3	-0-	825.73 ^d	825.73	10,000.00
	<u>\$ -0-</u>	<u>\$2,278.20</u>	<u>\$2,278.20</u>	

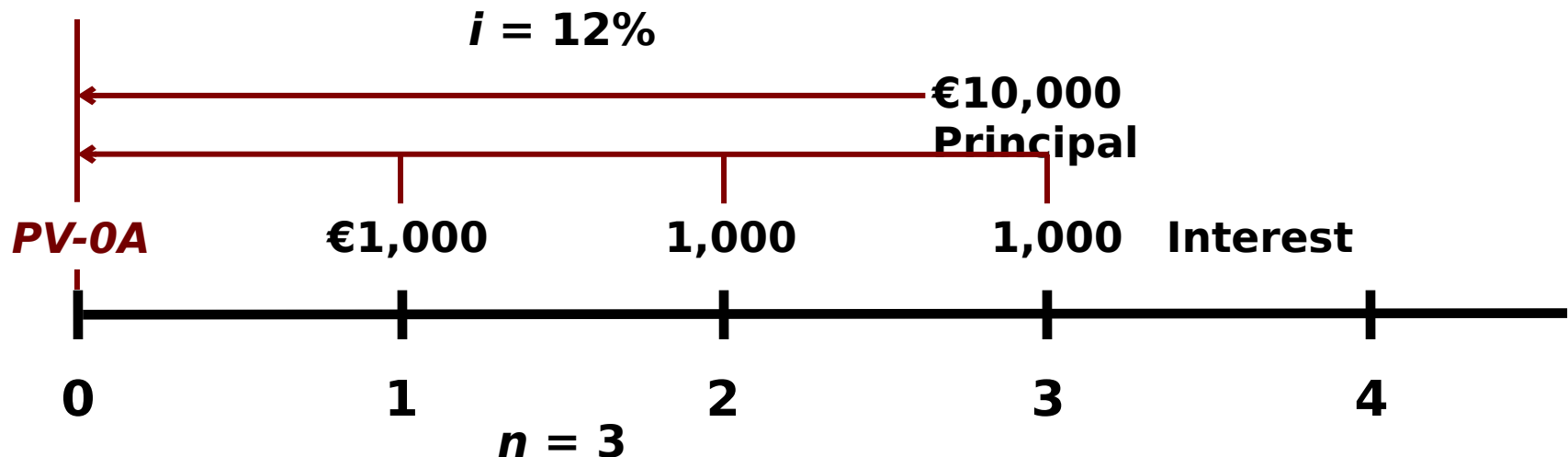
Record interest revenue at the end of the first year.

Notes Receivable 694.96

Interest Revenue (\$7,721.80 x 9%) 694.96

Interest-Bearing Notes

Illustration: Morgan Corp. makes a loan to Marie Co. and receives in exchange a three-year, €10,000 note bearing interest at 10 percent annually. The market rate of interest for a note of similar risk is 12 percent. Prepare the journal entry to record the receipt of the note?



Interest-Bearing Notes

PV of Interest

TABLE 6-4 PRESENT VALUE OF AN ORDINARY ANNUITY OF 1

8%	9%	10%	11%	12%	15%	(n) Periods
.92593	.91743	.90909	.90090	.89286	.86957	1
1.78326	1.75911	1.73554	1.71252	1.69005	1.62571	2
2.57710	2.53130	2.48685	2.44371	2.40183	2.28323	3
3.31213	3.23972	3.16986	3.10245	3.03735	2.85498	4
3.99271	3.88965	3.79079	3.69590	3.60478	3.35216	5
4.62288	4.48592	4.35526	4.23054	4.11141	3.78448	6
5.20637	5.03295	4.86842	4.71220	4.56376	4.16042	7
5.74664	5.53482	5.33493	5.14612	4.96764	4.48732	8
6.24689	5.99525	5.75902	5.53705	5.32825	4.77158	9
6.71008	6.41766	6.14457	5.88923	5.65022	5.01877	10

$$\begin{array}{ccccc}
 \text{€1,000} & \times & 2.40183 & = & \text{€2,402} \\
 \text{Interest} & & \text{Factor} & & \text{Present} \\
 \text{Received} & & & & \text{Value}
 \end{array}$$

Interest-Bearing Notes

PV of Principal

TABLE 6-2 PRESENT VALUE OF 1

8%	9%	10%	11%	12%	15%	(n) Periods
.92593	.91743	.90909	.90090	.89286	.86957	1
.85734	.84168	.82645	.81162	.79719	.75614	2
.79383	.77218	.75132	.73119	.71178	.65752	3
.73503	.70843	.68301	.65873	.63552	.57175	4
.68058	.64993	.62092	.59345	.56743	.49718	5
.63017	.59627	.56447	.53464	.50663	.43233	6
.58349	.54703	.51316	.48166	.45235	.37594	7
.54027	.50187	.46651	.43393	.40388	.32690	8
.50025	.46043	.42410	.39092	.36061	.28426	9
.46319	.42241	.38554	.35218	.32197	.24719	10

$$\begin{array}{ccccc}
 \text{€10,000} & \times & .71178 & = & \text{€7,118} \\
 \text{Principal} & & \text{Factor} & & \text{Present Value}
 \end{array}$$

Interest-Bearing Notes

Illustration: Record the receipt of the note?

ILLUSTRATION 7-16
Computation of Present
Value—Effective Rate
Different from Stated
Rate

Face value of the note		€10,000
Present value of the principal:		
€10,000 ($PVF_{3,12\%}$) = €10,000 × .71178	€7,118	
Present value of the interest:		
€1,000 ($PVF-OA_{3,12\%}$) = €1,000 × 2.40183	<u>2,402</u>	
Present value of the note		<u>9,520</u>
Difference (Discount)		<u><u>€ 480</u></u>

Notes Receivable	9,520
Cash	9,520

Interest-Bearing Notes

SCHEDULE OF NOTE DISCOUNT AMORTIZATION EFFECTIVE-INTEREST METHOD 10% NOTE DISCOUNTED AT 12%

	<u>Cash Received</u>	<u>Interest Revenue</u>	<u>Discount Amortized</u>	<u>Carrying Amount of Note</u>
Date of issue				€ 9,520
End of year 1	€1,000 ^a	€1,142 ^b	€142 ^c	9,662 ^d
End of year 2	1,000	1,159	159	9,821
End of year 3	1,000	1,179	179	10,000
	<u>€3,000</u>	<u>€3,480</u>	<u>€480</u>	

^a€10,000 × 10% = €1,000

^c€1,142 – €1,000 = €142

^b€9,520 × 12% = €1,142

^d€9,520 + €142 = €9,662

ILLUSTRATION 7-17

Discount Amortization Schedule
—Effective-Interest Method

Interest-Bearing Notes

ILLUSTRATION 7-17

Discount Amortization Schedule
—Effective-Interest Method

SCHEDULE OF NOTE DISCOUNT AMORTIZATION EFFECTIVE-INTEREST METHOD 10% NOTE DISCOUNTED AT 12%				
	<u>Cash Received</u>	<u>Interest Revenue</u>	<u>Discount Amortized</u>	<u>Carrying Amount of Note</u>
Date of issue				€ 9,520
End of year 1	€1,000 ^a	€1,142 ^b	€142 ^c	9,662 ^d
End of year 2	1,000	1,159	159	9,821
End of year 3	1,000	1,179	179	10,000
	<u>€3,000</u>	<u>€3,480</u>	<u>€480</u>	

Record interest revenue at the end of the first year.

Cash	1,000	
Notes Receivable	142	
Interest Revenue		1,142

Notes Receivable

Notes Received for Property, Goods, or Services

In a bargained transaction entered into at arm's length, the stated interest rate is presumed to be fair unless:

1. No interest rate is stated, or
2. Stated interest rate is unreasonable, or
3. Face amount of the note is materially different from the
 - ◆ current cash sales price or
 - ◆ from the current market value of the debt instrument.

Notes for Property, Goods, or Services

Illustration: Oasis Development Co. sold a corner lot to Rusty Pelican as a restaurant site. Oasis accepted in exchange a five-year note having a maturity value of £35,247 and no stated interest rate. The land originally cost Oasis £14,000. At the date of sale the land had a fair market value of £20,000. Oasis uses the fair market value of the land, £20,000, as the present value of the note. Oasis therefore records the sale as:

Notes Receivable 20,000

Land 14,000

Gain on Sale of Land (£20,000 - £14,000) 6,000

Valuation of Notes Receivable

- ◆ **Short-Term** reporting parallels that for trade accounts receivable.
- ◆ **Long-Term**
 - ▶ Value may change over time as a discount or premium is amortized.
 - ▶ Impairment
 - Tests often done on an individual assessment basis.
 - Losses measured as the difference between the carrying value of the receivable and the present value of the estimated future cash flows discounted at the original effective-interest rate.

Valuation of Notes Receivable

Illustration: Tesco Inc. has a note receivable with a carrying amount of €200,000. The debtor, Morganese Company, has indicated that it is experiencing financial difficulty. Tesco decides that Morganese's note receivable is therefore impaired. Tesco computes the present value of the future cash flows discounted at its original effective-interest rate to be €175,000. The computation of the loss on impairment is as

Carrying amount of note receivable	€ 200,000
Present value of note receivable	(175,000)
Impairment loss	<u>€ 25,000</u>

Valuation of Notes Receivable

The computation of the loss on impairment is as follows.

Carrying amount of note receivable	€ 200,000
Present value of note receivable	(175,000)
Impairment loss	<u>€ 25,000</u>

The entry to record the impairment loss is as follows.

Bad Debt Expense	25,000	
Allowance for Doubtful Accounts		25,000

SPECIAL ISSUES

Fair Value Option

- ◆ Companies have the option to record fair value in their accounts for most financial assets and liabilities, including receivables.
- ◆ If companies choose the **fair value option**
 - ▶ Receivables are recorded at fair value.
 - ▶ Unrealized holding gains or losses reported as part of net income.
- ◆ Company reports the receivable at fair value each reporting date.

SPECIAL ISSUES

Fair Value Option

- ◆ Companies may elect to use the **fair value option** at the time the receivable is
 - ▶ originally recognized or
 - ▶ when some event triggers a new basis of accounting.
- ◆ Must continue to use fair value measurement for that receivable until the company no longer owns this receivable.
- ◆ If not elected at date of recognition, company may not use the fair value option on that specific receivable.

Recording Fair Value Option

Illustration: Escobar Company has notes receivable that have a fair value of R\$810,000 and a carrying amount of R\$620,000. Escobar decides on December 31, of the current year, to use the **fair value option** for these receivables. This is the first valuation of these recently acquired receivables. At December 31, Escobar makes an adjusting entry to record the increase in value of Notes Receivable and to record the unrealized holding gain, as follows:

Notes Receivable 190,000

Unrealized Holding Gain or Loss—Income
190,000

SPECIAL ISSUES

Derecognition of Receivables

Transfer (e.g., sell) receivables to another company for cash.

Reasons:

- ◆ Accelerate the receipt of cash.
- ◆ Competition.
- ◆ Sell receivables because money is tight.
- ◆ Billing / collection are time-consuming and costly.

Transfer accomplished by:

1. Secured borrowing
2. Sale of receivables

Derecognition of Receivables

Secured Borrowing

Using receivables as collateral in a borrowing transaction.

Illustration: On March 1, 2015, Meng Mills, Inc. provides (assigns) NT\$700,000 of its accounts receivable to Sino Bank as collateral for a NT\$500,000 note. Meng Mills continues to collect the accounts receivable; the account debtors are not notified of the arrangement. Sino Bank assesses a finance charge of 1 percent of the accounts receivable and interest on the note of 12 percent. Meng Mills makes monthly payments to the bank for all cash it collects on the receivables.

Secured Borrowing

ILLUSTRATION 7-18 Entries for Transfer of Receivables—Secured Borrowing

Borrowing

Meng Mills, Inc.			Sino Bank		
Transfer of accounts receivable and issuance of note on March 1, 2015					
Cash	493,000		Notes Receivable	500,000	
Interest Expense	7,000*		Interest Revenue		7,000*
Notes Payable		500,000	Cash		493,000
*(NT\$700,000 × .01)					
Collection in March of NT\$440,000 of accounts less cash discounts of NT\$6,000 plus receipt of NT\$14,000 sales returns					
Cash	434,000				
Sales Discounts	6,000				
Sales Returns and Allowances	14,000		(No entry)		
Accounts Receivable		454,000*			
*(NT\$440,000 + NT\$14,000 = NT\$454,000)					
Remitted March collections plus accrued interest to the bank on April 1, 2015					
Interest Expense	5,000*		Cash	439,000	
Notes Payable	434,000		Interest Revenue		5,000*
Cash		439,000	Notes Receivable		434,000
*(NT\$500,000 × .12 × 1/12)					
Collection in April of the balance of accounts less NT\$2,000 written off as uncollectible					
Cash	244,000				
Allowance for Doubtful Accounts	2,000		(No entry)		
Accounts Receivable		246,000*			
*(NT\$700,000 – NT\$454,000)					
Remitted the balance due of NT\$66,000 (NT\$500,000 – NT\$434,000) on the note plus interest on May 1, 2015					
Interest Expense	660*		Cash	66,660	
Notes Payable	66,000		Interest Revenue		660*
Cash		66,660	Notes Receivable		66,000
*(NT\$66,000 × .12 × 1/12)					

Meng Mills, Inc.Sino Bank**Transfer of accounts receivable and issuance of note on March 1, 2015**

Cash	493,000		Notes Receivable	500,000	
Interest Expense	7,000*		Interest Revenue		7,000*
Notes Payable		500,000	Cash		493,000
*(NT\$700,000 × .01)					

Collection in March of NT\$440,000 of accounts less cash discounts of NT\$6,000 plus receipt of NT\$14,000 sales returns

Cash	434,000			
Sales Discounts	6,000			
Sales Returns and Allowances	14,000		(No entry)	
Accounts Receivable		454,000*		
*(NT\$440,000 + NT\$14,000 = NT\$454,000)				

Remitted March collections plus accrued interest to the bank on April 1, 2015

Interest Expense	5,000*		Cash	439,000	
Notes Payable	434,000		Interest Revenue		5,000*
Cash		439,000	Notes Receivable		434,000
*(NT\$500,000 × .12 × 1/12)					

Collection in April of the balance of accounts less NT\$2,000 written off as uncollectible

Cash	244,000			
Allowance for Doubtful Accounts	2,000		(No entry)	
Accounts Receivable		246,000*		
*(NT\$700,000 – NT\$454,000)				

Remitted the balance due of NT\$66,000 (NT\$500,000 – NT\$434,000) on the note plus interest on May 1, 2015

Interest Expense	660*		Cash	66,660	
Notes Payable	66,000		Interest Revenue		660*
Cash		66,660	Notes Receivable		66,000
*(NT\$66,000 × .12 × 1/12)					

Secured Borrowing

Illustration: On April 1, 2015, Prince Company assigns \$500,000 of its

accounts receivable to the Hibernia Bank as collateral for a \$300,000 loan due July 1, 2015. The assignment agreement calls for Prince Company to continue to collect the receivables. Hibernia 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

Instructions: note of this type).

- a) Prepare the April 1, 2015, journal entry for Prince Company.
- b) Prepare the journal entry for Prince's collection of \$350,000 of the accounts receivable during the period from April 1, 2015, through June 30, 2015.
- c) On July 1, 2015, Prince paid Hibernia all that was due from the loan it secured on April 1, 2015.

Secured Borrowing

Instructions:

- a) Prepare the April 1, 2015, journal entry for Prince Company.
- b) Prepare the journal entry for Prince's collection of \$350,000.
- c) On July 1, 2015, Prince paid Hibernia all that was due from the loan it secured on April 1, 2015.

a) Cash 290,000
 Finance Charge ($\$500,000 \times 2\%$) 10,000
 Notes Payable 300,000

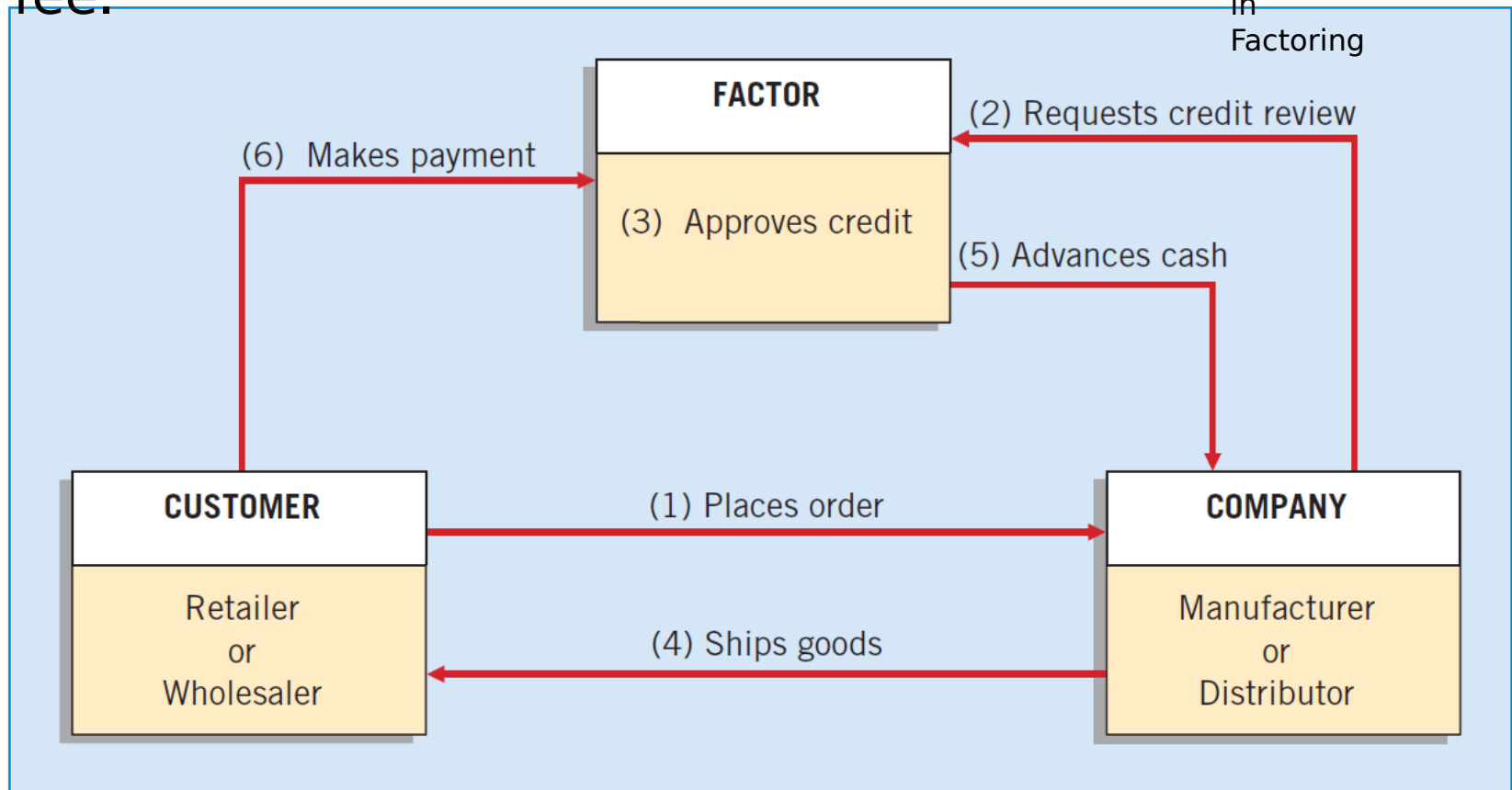
b) Cash 350,000
 Accounts Receivable 350,000

c) Notes Payable 300,000
 Interest Expense ($10\% \times \$300,000 \times 3/12$) 7,500
 Cash 307,500

Sales of Receivables

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

ILLUSTRATION 7-19
Basic Procedures
in
Factoring



Sales of Receivables

Sale without Guarantee

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

Sale without Guarantee

Illustration: Crest Textiles, Inc. factors €500,000 of accounts receivable with Commercial Factors, Inc., on a **non-guarantee** basis. Commercial Factors assesses a finance charge of 3 percent of the amount of accounts receivable and retains an amount equal to 5 percent of the accounts receivable (for probable adjustments). Crest Textiles and Commercial Factors make the following journal entries for the receivables transferred without guarantee.

Crest Textiles, Inc.		Commercial Factors, Inc.	
Cash	460,000	Accounts (Notes) Receivable	500,000
Due from Factor	25,000*	Due to Customer (Crest Textiles)	25,000
Loss on Sale of Receivables	15,000**	Interest Revenue	15,000
Accounts (Notes) Receivable	500,000	Cash	460,000
*(5% × €500,000)	** (3% × €500,000)		

ILLUSTRATION 7-20

Entries for Sale of Receivables without Guarantee

Sales of Receivables

Sale with Guarantee

- ◆ Seller guarantees payment to purchaser.
- ◆ Transfer is considered a borrowing—sometimes referred to as a **failed sale**.

Assume Crest Textiles sold the receivables on a **with guarantee** basis.

ILLUSTRATION 7-21

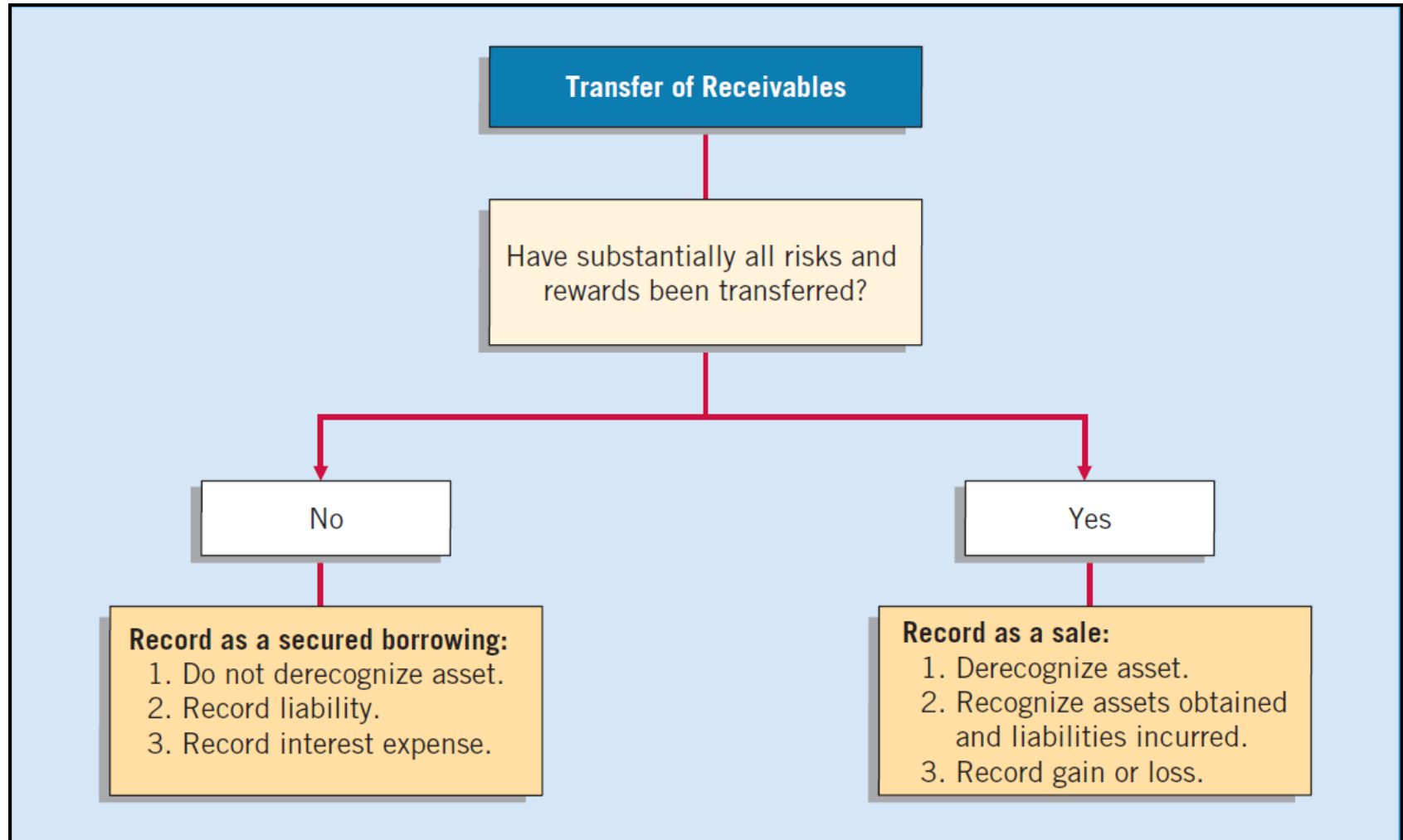
Sale with Guarantee

Crest Textiles		Commercial Factors	
Cash	460,000	Accounts Receivable	500,000
Due from Factor	25,000	Due to Customer	
Finance Charge	15,000	(Crest Textiles)	25,000
Recourse Liability	500,000	Interest Revenue	15,000
		Cash	460,000

Summary of Transfers

ILLUSTRATION 7-22

Accounting for Transfers of Receivables



Presentation and Analysis

General rules in classifying receivables are:

1. Segregate and report carrying amounts of different categories of receivables.
2. Indicate receivables classified as current and non-current in the statement of financial position.
3. Appropriately offset the valuation accounts for receivables that are impaired, including a discussion of individual and collectively determined impairments.
4. Disclose the fair value of receivables in such a way that permits it to be compared with its carrying amount.
5. Disclose information to assess the credit risk inherent in the receivables.
6. Disclose any receivables pledged as collateral.
7. Disclose all significant concentrations of credit risk arising from receivables.

Presentation and Analysis

Analysis of Receivables

ILLUSTRATION 7-24

Computation of
Accounts
Receivable Turnover

$$\frac{\text{Net Sales}}{\text{Average Trade Receivables (net)}} = \text{Accounts Receivable Turnover}$$

$$\frac{€28,103}{(€1,878 + €1,985)/2} = 15 \text{ times, or every 24.3 days } (365 \div 15)$$

This Ratio used to:

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



GLOBAL ACCOUNTING INSIGHTS

CASH AND RECEIVABLES

IFRS and U.S. GAAP are very similar in accounting for cash and receivables. For example, the definition of cash and cash equivalents is similar, and both IFRS and U.S. GAAP have a fair value option. In the wake of the international credit crisis, the Boards are working together to improve the accounting for loan impairments.



GLOBAL ACCOUNTING INSIGHTS

Relevant Facts

Following are the key similarities and differences between U.S. GAAP and IFRS related to cash and receivables.

Similarities

- The accounting and reporting related to cash is essentially the same under both U.S. GAAP and IFRS. In addition, the definition used for cash equivalents is the same.
- Cash and receivables are generally reported in the current assets section of the balance sheet under U.S. GAAP, similar to IFRS.
- U.S. GAAP requires that loans and receivables be accounted for at amortized cost, adjusted for allowances for doubtful accounts, similar to IFRS.



GLOBAL ACCOUNTING INSIGHTS

Relevant Facts

Differences

- Under U.S. GAAP, cash and receivables are reported in order of liquidity. Under IFRS, companies may report cash and receivables as the last items in current assets.
- U.S. GAAP has explicit guidance concerning how receivables with different characteristics should be reported separately. There is no IFRS that mandates this segregation.
- The fair value option is similar under U.S. GAAP and IFRS but not identical. The international standard related to the fair value option is subject to certain qualifying criteria not in the U.S. standard. In addition, there is some difference in the financial instruments covered.



GLOBAL ACCOUNTING INSIGHTS

Relevant Facts

Differences

- Under U.S. GAAP, overdrafts are reported as liabilities. Under IFRS, bank overdrafts are generally reported as cash if such overdrafts are repayable upon demand and are an integral part of a company's cash management (offsetting arrangements against other accounts at the same bank).
- U.S. GAAP and IFRS differ in the criteria used to account for transfers of receivables. U.S. GAAP uses loss of control as the primary criterion. IFRS is a combination of an approach focused on risks and rewards and loss of control. In addition, U.S. GAAP does not permit partial transfers; IFRS generally does.



GLOBAL ACCOUNTING INSIGHTS

About the Numbers

In the accounting for loans and receivables, IFRS permits the reversal of impairment losses, with the reversal limited to the asset's amortized cost before the impairment. To illustrate, Zirbel Company has a loan receivable with a carrying value of \$10,000 at December 31, 2014. On January 2, 2015, the borrower declares bankruptcy, and Zirbel estimates that it will collect only one-half of the loan balance. Zirbel makes the following entry to record the impairment.

Impairment Loss	5,000	
Loan Receivable		5,000



GLOBAL ACCOUNTING INSIGHTS

About the Numbers

On January 10, 2016, Zirbel learns that the customer has emerged from bankruptcy. Zirbel now estimates that all but \$1,000 will be repaid on the loan. Under IFRS, Zirbel records this reversal as follows.

Loan Receivable	4,000	
Recovery of Impairment Loss		4,000

Zirbel reports the recovery in 2016 income. Under U.S. GAAP, reversal of an impairment is not permitted. Rather, the balance on the loan after the impairment becomes the new basis for the loan.



GLOBAL ACCOUNTING INSIGHTS

On the Horizon

Both the IASB and the FASB have indicated that they believe that financial statements would be more transparent and understandable if companies recorded and reported all financial instruments at fair value. The fair value option for recording financial instruments such as receivables is an important step in moving closer to fair value recording. Finally, the IASB is working on a new impairment model, which will be more forward-looking when evaluating financial instruments for impairment. The FASB is working on a similar impairment model. The final standards adopted, however, may not be fully converged in terms of the implementation details.

Management faces two problems in accounting for cash transactions:

1. Establish proper controls to prevent any unauthorized transactions by officers or employees.
2. Provide information necessary to properly manage cash on hand and cash transactions.

USING BANK ACCOUNTS

To obtain desired control objectives, a company can vary the number and location of banks and the types of accounts.

- ▶ General checking account
- ▶ Collection float
- ▶ Lockbox accounts
- ▶ Imprest bank accounts

THE IMPREST PETTY CASH SYSTEM

Used to pay small amounts for miscellaneous expenses.

Steps:

1. Record the transfer of \$300 to petty cash:

Petty Cash	300
Cash	300

2. Petty cash custodian obtains signed receipts from each individual to whom he or she pays cash.

THE IMPREST PETTY CASH SYSTEM

Steps:

3. Custodian receives a company check to replenish the fund.

Supplies Expense	42	
Postage Expense	53	
Miscellaneous Expense		76
Cash Over and Short	2	
Cash	173	

THE IMPREST PETTY CASH SYSTEM

Steps:

4. If the company decides that the amount of cash in the petty cash fund is excessive by \$50, it lowers the fund balance as follows.

Cash	50	
Petty cash		50

PHYSICAL PROTECTION OF CASH BALANCES

Company should

- ◆ Minimize the cash on hand.
- ◆ Only have on hand petty cash and current day's receipts.
- ◆ Keep funds in a vault, safe, or locked cash drawer.
- ◆ Transmit each day's receipts to the bank as soon as practicable.
- ◆ Periodically prove the balance shown in the general ledger.

RECONCILIATION OF BANK BALANCES

Schedule explaining any differences between the bank's and the company's records of cash.

Reconciling Items:

1. Deposits in transit.
2. Outstanding checks.
3. Bank charges
4. Bank credits.
5. Bank or depositor errors.



**Time
Lags**

RECONCILIATION OF BANK BALANCES

Balance per bank statement (end of period)		\$\$\$
Add: Deposits in transit	\$\$	
Undeposited receipts (cash on hand)	\$\$	
Bank errors that understate the bank statement balance	\$\$	\$
		<u>\$\$\$</u>
Deduct: Outstanding checks	\$\$	
Bank errors that overstate the bank statement balance	\$\$	\$
Correct cash balance		<u><u>\$\$\$</u></u>
Balance per depositor's books		\$\$\$
Add: Bank credits and collections not yet recorded in the books	\$\$	
Book errors that understate the book balance	\$\$	\$
		<u>\$\$\$</u>
Deduct: Bank charges not yet recorded in the books	\$\$	
Book errors that overstate the book balance	\$\$	\$
Correct cash balance		<u><u>\$\$\$</u></u>

ILLUSTRATION 7A- 1

Bank Reconciliation
Form and Content

RECONCILIATION OF BANK BALANCES

To illustrate, Nugget Mining Company's books show a cash balance at the Melbourne Bank on November 30, 2015, of \$20,502. The bank statement covering the month of November shows an ending balance of \$22,190. An examination of Nugget's accounting records and November bank statement identified the following reconciling items.

1. A deposit of \$3,680 that Nugget mailed November 30 does not appear on the bank statement.
2. Checks written in November but not charged to the November bank statement are:

Check #7327	\$ 150
#7348	4,820
#7349	31

3. Nugget has not yet recorded the \$600 of interest collected by the bank November 20 on Sequoia Co. bonds held by the bank for Nugget.
4. Bank service charges of \$18 are not yet recorded on Nugget's books.
5. The bank returned one of Nugget's customer's checks for \$220 with the bank statement, marked "NSF." The bank deducted \$220 from Nugget's account.
6. Nugget discovered that it incorrectly recorded check #7322, written in November for \$131 in payment of an account payable, as \$311.
7. A check for Nugent Oil Co. in the amount of \$175 that the bank incorrectly charged to Nugget accompanied the statement.

RECONCILIATION OF BANK BALANCES

NUGGET MINING COMPANY BANK RECONCILIATION MELBOURNE BANK, NOVEMBER 30, 2015

**ILLUSTRATION
7A-2**
Sample Bank
Reconciliation

Balance per bank statement (end of period)	\$22,190
--	----------

Add:

Deduct:

Correct cash balance

Balance per books	\$20,502
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Add:

Deduct:

Correct cash balance

RECONCILIATION OF BANK BALANCES

Journalize the required adjusting entries at November 30.

Cash 600
 Interest Revenue 600
(To record interest on Sequoia Co. bonds, collected by bank)

Cash 180
 Accounts Payable 180
(To correct error in recording amount of check #7322)

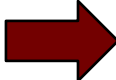
Office Expense (bank charges) 18
 Cash 18
(To record bank service charges for November)

Accounts Receivable 220
 Cash 220
(To record customer's check returned NSF)

RECONCILIATION OF BANK BALANCES

Question

The reconciling item in a bank reconciliation that will result in an adjusting entry by the depositor is:

- a. outstanding checks.
- b. deposit in transit.
- c. a bank error.
-  d. bank service charges.

APPENDIX 7B

IMPAIRMENTS OF RECEIVABLES

Companies assess their receivables for impairment each reporting period.

Examples of possible loss events are:

- ▶ Significant financial problems of the customer.
- ▶ Payment defaults.
- ▶ Renegotiation of terms of the receivable.

In this appendix, we discuss impairments based on the **individual assessment approach** for long-term receivables.

IMPAIRMENT MEASUREMENT AND REPORTING

Impairment loss is calculated as the difference between:

- ▶ the carrying amount (generally the principal plus accrued interest) and
- ▶ the expected future cash flows discounted at the loan's historical effective-interest rate.

In estimating future cash flows, the creditor should use reasonable and supportable assumptions and projections.

Impairment Loss Example

Illustration: At December 31, 2014, Ogden Bank recorded an investment of €100,000 in a loan to Carl King. The loan has an historical effective-interest rate of 10 percent, the principal is due in full at maturity in three years, and interest is due annually. The loan officer performs a review of the loan's expected future cash flow and utilizes the present value method for measuring the required impairment loss.

<u>Dec. 31</u>	<u>Contractual Cash Flow</u>	<u>Expected Cash Flow</u>	<u>Loss of Cash Flow</u>
2015	€ 10,000	€ 5,000	€ 5,000
2016	10,000	5,000	5,000
2017	110,000	105,000	5,000
Total cash flows	<u>€130,000</u>	<u>€115,000</u>	<u>€15,000</u>

ILLUSTRATION 7B-1

Impaired Loan Cash Flows

Recording Impairment Losses

Illustration: Computation of Impairment

ILLUSTRATION 7B-2

Computation of
Impairment Loss

Recorded investment		€100,000
Less: Present value of €100,000 due in 3 years at 10% (Table 6-2); $FV (PVF_{3,10\%})$; $(€100,000 \times .75132)$	€75,132	
Present value of €5,000 interest receivable annually for 3 years at 10% R ($PVF-OA_{3,10\%}$); $(€5,000 \times 2.48685)$	<u>12,434</u>	<u>87,566</u>
Loss on impairment		<u><u>€ 12,434</u></u>

Journal entry to record the loss

Bad Debt Expense 12,434

 Allowance for Doubtful Accounts
 12,434

Recovery of Impairment Loss

Illustration: Assume that in the year following the impairment recorded by Ogden, Carl King has worked his way out of financial difficulty. Ogden now expects to receive all payments on the loan according to the original loan terms. Based on this new information, the present value of the expected payments is €100,000. Thus, Ogden makes the following entry to reverse the previously recorded impairment.

Allowance for Doubtful Accounts	12,434
Bad Debt Expense	12,434