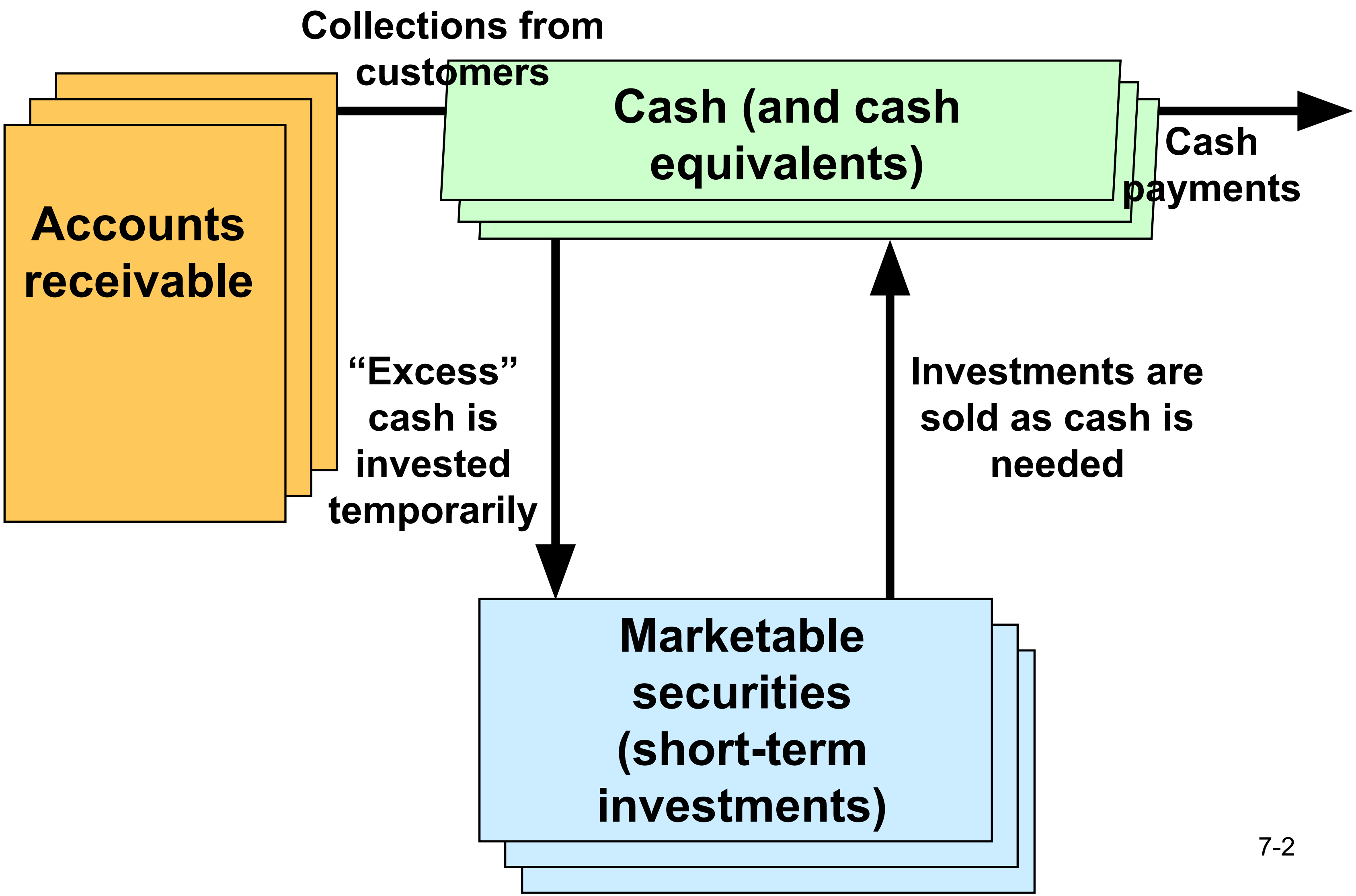
Financial Assets

Chapter 7

How Much Cash Should a Business Have?



The Valuation of Financial Assets

Type of Financial Assets	Basis for Valuation in the Balance Sheet
Cash (and cash equivalents)	Face amount
Short-term investments (marketable securities)	Current market value
Receivables	Net realizable value

Estimated collectible amount

Cash

Coins and paper money

Checks

Cash is defined as any deposit banks will accept.

Bank credit card sales

Money orders

Travelers' checks

Reporting Cash in the Balance Sheet

Cash Equivalents

Restricted Cash

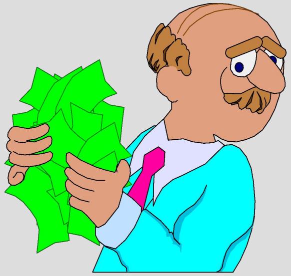
Line of Credit

Cash Management

- Accurately account for cash.
- Prevent theft and fraud.
- Assure the availability of adequate amounts of cash.
- Prevent unnecessarily large amounts of idle cash.

Internal Control Over Cash

- Segregate authorization, custody and recording of cash.
- Prepare a cash budget (or forecast).
- Prepare a control listing of cash receipts.
- Require daily deposits.
- Make all payments by check.
- Require that every expenditure be verified before payment.
- Promptly reconcile bank statements.



Cash Over and Short

On May 5, XBAR, Inc.'s cash drawer was counted and found to be $10 over.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
May	5	Cash	10	
		Cash Over and Short		10

Cash Over and Short is debited for shortages and credited for overages.

Reconciling the Bank Statement
Согласование выписки с банковского счета

Explains the difference between cash reported on bank statement and cash balance in depositor's accounting records.

Provides information for reconciling journal entries.

Reconciling the Bank Statement

- Balance per Bank
- + Deposits in Transit
- - Outstanding Checks
- ± Bank Adjustments
- = Adjusted Balance

- Balance per Depositor
- + Deposits by Bank (credit memos)
- - Service Charge
- - NSF Checks
- ± Book Adjustments
- = Adjusted Balance

Reconciling the Bank Statement

- The July 31 bank statement for Simmons Company indicated a cash balance of $9,610
- The cash ledger account on that date shows a balance of $7,430.
- Outstanding checks totaled $2,417.
- A $500 check mailed to the bank for deposit had not reached the bank at the statement date.
- The bank returned a customer's NSF check for $225 received as payment of an account receivable.
- The bank statement showed $30 interest earned on the bank balance for the month of July.
- Check 781 for supplies cleared the bank for $268 but was erroneously recorded in our books as $240.
- A $486 deposit by Acme Company was erroneously credited to our account by the bank.

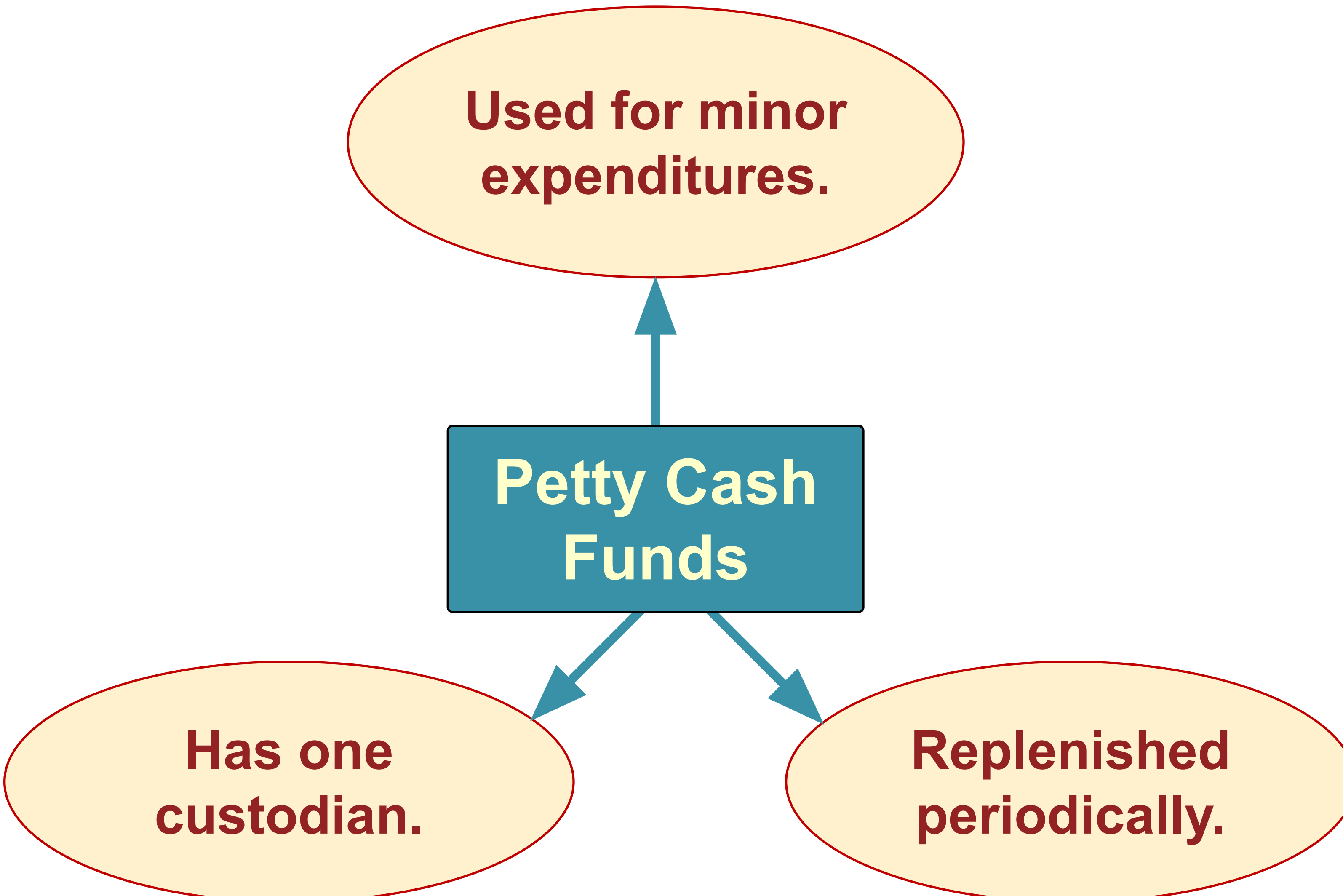
Reconciling the Bank Statement

Balance per bank statement, July 31			$	9,610
Additions:				
Deposit in transit				500
Deductions:				
Bank error	$	486		
Outstanding checks		2,417		2,903
Adjusted cash balance			$	7,207
Balance per depositor's records, July 31			$	7,430
Additions:				
Interest				30
Deductions:				
Recording error	$	28		
NSF check		225		253
Adjusted cash balance			$	7,207

Reconciling the Bank Statement

GENERAL JOURNAL				
Date		Account Titles and Explanation	Debit	Credit
Jul	31	Cash	30	
		Interest Revenue		30
	31	Supplies Inventory	28	
		Accounts Receivable	225	
		Cash		253

Petty Cash Funds



Short-Term Investments

Bond Investments

Capital Stock Investments

Marketable Securities are . . .

Readily Marketable

Current Assets

Almost As Liquid As Cash

Purchase of Marketable Securities

Foster Corporation purchases as a short-term investment 4,000 shares of The Coca-Cola Company on December 1. Foster paid $48.98 per share, plus a brokerage commission of $80.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Dec	1	Marketable Securities	196,000	
		Cash		196,000

Total Cost: (4,000 × $48.98) + $80 = $196,000

Cost per Share: $196,000 ÷ 4,000 = $49.00

Recognition of Investment Revenue

On December 15, Foster Corporation receives a $0.30 per share dividend on its 4,000 shares of Coca-Cola.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Dec	15	Cash	1,200	
		Dividend Revenue		1,200

$4,000 \times \$0.30 = \$1,200$

Sales of Investments

On December 18, Foster Corporation sells 500 shares of its Coca-Cola stock for $50.04 per share, less a $20 brokerage commission.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Dec	18	Cash	25,000	
		Marketable Securities		24,500
		Gain on Sale of Investment		500

Sales Proceeds: (500 × $50.04) - $20 = $25,000
Cost Basis: 500 × $49 = $24,500
Gain on Sale: $25,000 - $24,500 = $500

Adjusting Marketable Securities to Market Value

On December 31, Foster Corporation's remaining shares of Coca-Cola capital stock have a current market value of $47,000. Prior to any adjustment, the company's Marketable Securities account has a balance of $49,000 (1,000 × $49 per share).

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Dec	31	Unrealized Holding Loss on Investments	2,000	
		Marketable Securities		2,000

<u>Unrealized Loss:</u> $47,000 - $49,000 = ($2,000)

Reflecting Uncollectible Accounts in the Financial Statements

At the end of each period, record an estimate of the uncollectible accounts.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
		Uncollectible Accounts Expense	$$$$	
		Allowance for Doubtful Accounts		$$$$

Selling expense

Contra-asset account

The Allowance for Doubtful Accounts

The net realizable value is the amount of accounts receivable that the business expects to collect.

Accounts receivable
Less: Allowance for doubtful accounts
Net realizable value of accounts receivable

Writing Off an Uncollectible Account Receivable

When an account is determined to be uncollectible, it no longer qualifies as an asset and should be written off.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Jan.	5	Allowance for Doubtful Accounts	500	
		Accounts Receivable (J. Clark)		500

Writing Off an Uncollectible Account Receivable

	Before Write-Off	After Write-Off
Accounts receivable	$ 10,000	$ 9,500
Less: Allow. for doubtful accts.	2,500	2,000
Net realizable value	$ 7,500	$ 7,500

Notice that the $500 write-off did not change the net realizable value nor did it affect any income statement accounts.

Monthly Estimates of Credit Losses

At the end of each month, management should estimate the probable amount of uncollectible accounts and adjust the Allowance for Doubtful Accounts to this new estimate.

Two Approaches to Estimating Credit Losses:

1. **Balance Sheet Approach**
2. **Income Statement Approach**

Estimating Credit Losses — The Balance Sheet Approach

● Year-end Accounts Receivable is broken down into age classifications.

❷ Each age grouping has a different likelihood of being uncollectible.

● Compute a separate allowance for each age grouping.

Estimating Credit Losses — The Balance Sheet Approach

At December 31, the receivables for EastCo, Inc. were categorized as follows:

EastCo, Inc.
Schedule of Accounts Receivable by Age
December 31, 2009

Days Past Due	Accounts Receivable Balance	Estimated Bad Debts Percent	Estimated Uncollectible Amount
Current	$ 45,000	1%	$ 450
1 - 30	15,000	3%	450
31 - 60	5,000	5%	250
Over 60	2,000	10%	200
	$ 67,000		$ 1,350

❷

Estimating Credit Losses — The Balance Sheet Approach

EastCo's unadjusted balance in the allowance account is $500.
Per the previous computation, the desired balance is $1,350.

Allowance for Doubtful Accounts

	500
	850
	1,350

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Dec.	31	Uncollectible Accounts Expense	850	
		Allowance for Doubtful Accounts		850

Estimating Credit Losses — The Income Statement Approach

Uncollectible accounts' percentage is based on actual uncollectible accounts from prior years' credit sales.

	Net Credit Sales
×	**% Estimated Uncollectible**
	Amount of Journal Entry

Estimating Credit Losses — The Income Statement Approach

In 2009, EastCo had credit sales of $60,000. Historically, 1% of EastCo's credit sales has been uncollectible. For 2009, the estimate of uncollectible accounts expense is $600.

($60,000 × .01 = $600)

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
Dec.	31	Uncollectible Accounts Expense	600	
		Allowance for Doubtful Accounts		600

Recovery of an Account Receivable Previously Written Off

Subsequent collections require that the original write-off entry be reversed before the cash collection is recorded.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
		Accounts Receivable (X Customer)	$$$$	
		Allowance for Doubtful Accounts		$$$$
		Cash	$$$$	
		Accounts Receivable (X Customer)		$$$$

Direct Write-Off Method

This method makes no attempt to match revenues with the expense of uncollectible accounts.

GENERAL JOURNAL

Date		Account Titles and Explanation	Debit	Credit
June	15	Uncollectible Accounts Expense	$$$$	
		Accounts Receivable (X Customer)		$$$$

Internal Controls for Receivables

Separate the following duties:

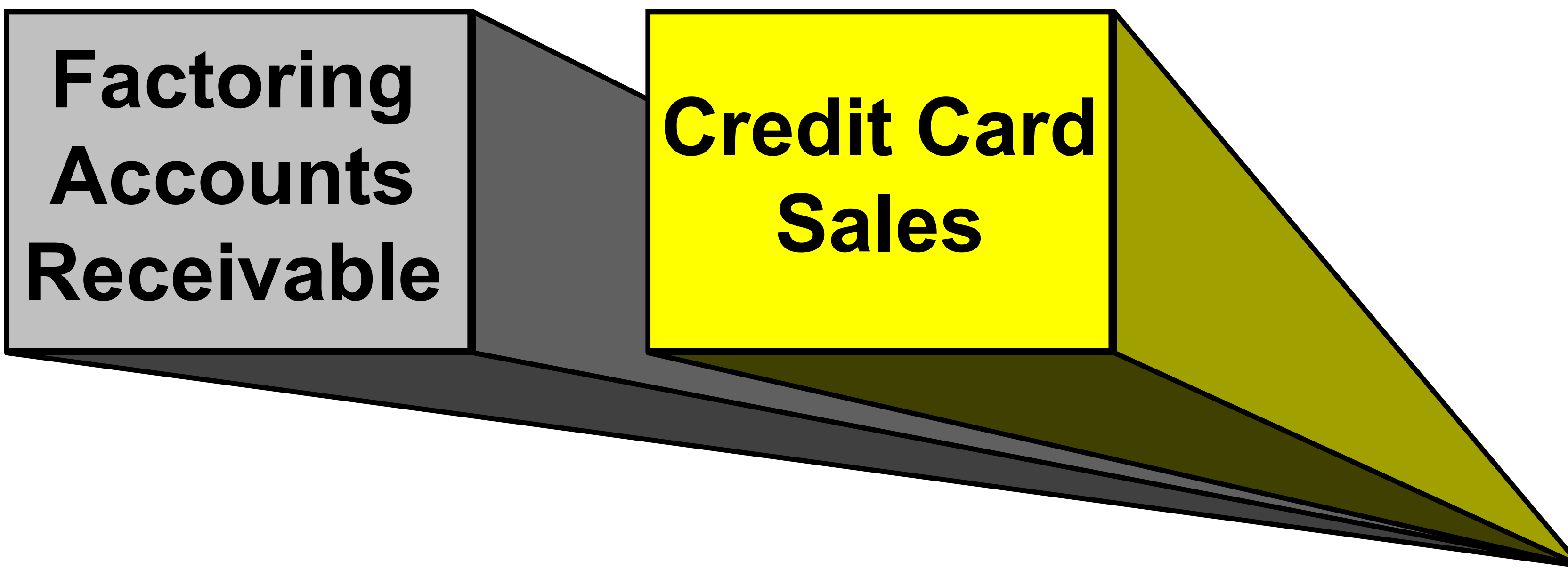
- Maintenance of the accounts receivable subsidiary ledger.

❷ Custody of cash receipts.

- Authorization of accounts receivable write-offs.

Management of Accounts Receivable

Extending credit encourages customers to buy from us but it ties up resources in accounts receivable.



Notes Receivable and Interest Revenue

A promissory note is an unconditional promise in writing to pay on demand or at a future date a definite sum of money.

Maker—the person who signs the note and thereby promises to pay.

Payee—the person to whom payment is to be made.

Notes Receivable and Interest Revenue

The interest formula includes three variables:

Interest = Principal × Interest Rate × Time

When computing interest for one year, "Time" equals 1. When the computation period is less than one year, then "Time" is a fraction.

For example, if we needed to compute interest for 3 months, "Time" would be $^3/_{12}$.

Notes Receivable and Interest Revenue

On November 1, Hall Company loans $10,000 to Porter Company on a 90-day note earning 12 percent interest. On December 31st, Hall Company needs an adjusting entry to record the interest revenue on the Porter Company note.

Date	Description	Debit	Credit
Dec. 31	Interest Receivable	200	
	Interest Revenue		200

$$\$10{,}000 \times 12\% \times {}^{60}/_{360} = \$200$$

Notes Receivable and Interest Revenue

What entry would Hall Company make on the maturity date?

$$\$10{,}000 \times 12\% \times {}^{90}/_{360} = \$300$$

Date	Description	Debit	Credit
Jan. 30	Cash	10,300	
	Interest Receivable		200
	Interest Revenue		100
	Notes Receivable		10,000

Days remaining in November (30-1)	29
Days in December	31
Days needed in January	30
Note term in Days	90

Financial Analysis and Decision Making

Accounts Receivable Turnover Rate

This ratio provides useful information for evaluating how efficient management has been in granting credit to produce revenue.

$$\frac{\textbf{Net Sales}}{\textbf{Average Accounts Receivable}}$$

Financial Analysis and Decision Making

<u>Avg. Number of Days to Collect A/R</u>

This ratio helps judge the liquidity of a company's accounts receivable.

$$\frac{\textbf{Days in Year}}{\textbf{Accounts Receivable Turnover Ratio}}$$

End of Chapter 7