Chapter 4

Cash, Receivables, and Controls

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Learning Objectives

- Define cash and cash equivalents.
- Understand cash control principles and concepts.
- Prepare the bank reconciliation and related adjusting entries.
- Know how to establish and control a petty cash system.
- Understand the accounting concepts and methods pertaining to receivables in a healthcare environment.
- Master basic calculations and accounting techniques for notes receivable.

Chapter Outline

Introduction

Cash is an interesting asset. It is usually not the most important asset a company possesses, and it is not a very productive asset. However, try to operate without it, and the results are usually and quickly fatal. It is the accepted medium of exchange and represents the "blood supply" to keep the business functioning. Therefore, proper cash management and control is highly important to business success.

4.1 Concepts of Cash

Cash includes currency, coins, bank demand deposits that can be freely withdrawn, undeposited checks from patients or insurers, and other items that are acceptable to a bank for deposit. Some items may seem like cash but are not classified that way: certificates of deposit, IOUs, stamps, and travel advances. These items are reported as investments, supplies, or other more descriptive classifications.

Some companies will expand their reporting of cash to include **cash equivalents**. These are very short-term (usually interest-earning) financial instruments like government Treasury bills. They are typically deemed secure and will convert back into cash within 90 days. They are close enough to cash that they are considered to be available to satisfy obligations, and proper cash management strategies tend to discourage hoarding of large pools of unproductive currency deposits.

Cash Management and Control

Cash management requires proper balancing to maintain sufficient cash to meet obligations as they come due and to make sure that idle cash is invested to generate returns on business assets. Larger organizations may create the position of **treasurer**, whose job is to manage the business's cash flows. This person may be responsible for preparing a cash budget, which is a major component of the cash-planning system. It anticipates and depicts cash inflows and outflows for a stated period of time. This tool helps identify and adjust for anticipated periods of cash deficits or surpluses. Based on advance knowledge gained via the cash-budgeting process, a company then has time to develop appropriate strategies to deal with the anticipated potential cash needs.

Companies must also implement strong systems of cash control. Cash controls are intended to safeguard funds and include the following:

- Limiting access to cash;
- Separating incompatible duties (e.g., the person maintaining the cash records should not reconcile bank accounts); and
- Instituting accountability features such as prenumbered checks and dual signatures.

Typical processes ordinarily maintain a continuous system of accountability and access control from the time a payment is accepted from the patient or insurer to the time it is deposited at the bank. In the healthcare environment, partial payment is usually received from the patient and the rest of the money comes from an insurer, which could be an insurance company or a governmental source such as Medicare or Medicaid. Table 4.1 highlights some significant control features, which you should consider implementing in almost any business environment, for cash receipts.

Table 4.1: Control features for cash receipts

Features to Consider
Use computer terminals to record cash transactions from patients.
Daily, compare cash to daily computer summary.
Daily, deposit receipts in the bank.
The person opening the mail immediately restrictively endorses (e.g., for deposit only) checks received.
The person opening the mail immediately prepares a checklist that is forwarded to the accounting department, where patient records are updated to show payments.
The person opening the mail immediately forwards all checks to the employee who handles cash deposits.

In reviewing Table 4.1, it is important to note that actual checks are immediately separated from the accounting for those receipts. Separation of duties is a paramount control feature; the person recording the checks in the accounting records is deliberately not the person making the deposit. Later, another person will be charged with comparing company cash records with actual cash on deposit at the bank. By involving multiple parties, it becomes much harder for any one person to commit fraud, and collusion is usually necessary. When it requires multiple persons to coordinate activities to perpetuate a fraud, the risk of fraud is greatly diminished.

Disbursements of cash also entail procedures that are intended to permit only authorized payments for actual expenditures. Table 4.2 highlights some significant control features, which you should consider implementing in almost any business environment, for cash disbursement.

Table 4.2: Control features for cash disbursement

Features to Consider
Use a check (or credit card) to make significant disbursements.
Someone not otherwise regularly involved in the cash business cycle should regularly reconcile bank accounts.
Use formal petty cash procedures for small disbursements.
Establish a proper system of authorization for approval of significant disbursements.
Set up bank accounts that require dual signatures for large disbursements.

You should already be performing a bank reconciliation of your own checking account. Mostly, you perform this process to make sure that your records are correct and agree with the bank's records. Businesses should reconcile each of their bank accounts. This process should be performed by a person not otherwise involved in the cash receipts and disbursements functions. For a business, the **bank reconciliation** is needed to identify errors, irregularities, and adjustments needed to the Cash account.

4.2 Bank Reconciliations

There is no single correct way to set up a schedule or worksheet format for the bank reconciliation. If you look at your monthly bank statement, you will probably see such a template in preprinted form using the bank's suggested schedule. However designed, the purpose of the reconciliation is to compare amounts on the **bank statement** (the document provided by the bank showing deposits, checks, other activity, and balances) with the cash amount contained in the company records. Identified differences help isolate errors and adjustments.

Differences between cash in the company records and the bank statement are caused by the following:

- Items reflected on company records but not yet recorded by the bank: (1) **Deposits in transit** are receipts entered on company records but not processed by the bank, and (2) **outstanding checks** are written checks that have not cleared the bank.
- Items noted on the bank statement but not recorded by the company: (1) **NSF (nonsufficient funds) checks**, which are previously deposited checks that have been returned for nonpayment; (2) bank service charges and fees; (3) interest earnings on the bank account(s); and (4) cash collections of notes and drafts.

The following example uses a popular two-column bank reconciliation approach. One column compares the balance per the bank statement to the correct cash balance. The second column reconciles the cash balance per company records to the same correct balance. It is imperative that the analysis is thorough so that the correct balance is obviously the same in each column.

Exhibit 4.1 shows the June 30, 20X5, bank reconciliation for Kaplan's Medical Clinic. The statement on the left is the bank statement, and the statement on the right is the company records. Notice that both columns arrive at the correct cash balance of $20,959.75.

Exhibit 4.1: Two statements for bank reconciliation for Kaplan's Medical Clinic on June 30, 20X5

Kaplan's Medical Clinic Bank Statement For the Month Ending June 30, 20X5		
Ending balance per bank statement		$ 16,878.90
Add:		
Deposit in transit		9,443.12
Deduct:		
Outstanding checks		
#451	$ 106.15	
#458	2,256.12	
#459	3,000.00	(5,362.27)
Correct cash balance		$ 20,959.75

Kaplan's Medical Clinic Records Statement For the Month Ending June 30, 20X5		
Ending balance per company records		$ 18,987.09
Add:		
Note and interest collected	$ 1,060.00	
Credit card postings	1,777.07	
Interest earnings	28.15	2,865.22
Deduct:		
Service charges	$ 75.00	
Electric bill ETF	376.56	
NSF Check	441.00	(892.56)
Correct cash balance		$ 20,959.75

The following additional data and items of information are needed to prepare and explain the bank reconciliation:

- The balance per the bank statement was $16,878.90.
- The balance per the bank statement failed to include a deposit in transit of $9,443.12.
- The bank balance had not yet been reduced by three checks (no. 451, 458, and 459) totaling $5,362.27.
- The balance per company records (taken from the Cash account in the general ledger and other records, such as a simple check register) is $18,987.09.
- The company's records had not yet been increased for a note and interest collected by the bank ($1,060).
- The company's records had not yet been increased for credit card postings to benefit the company's bank account (e.g., credit card payments from patients in the amount of $1,777.07).
- Interest earned on the bank account ($28.15) was not previously recorded by the company.
- The company records had not yet been reduced for bank service charges ($75.00), electronic funds transfers to pay a utility bill ($376.56), and a bounced (NSF) check ($441.00).

In preparing a bank reconciliation, the balance per the bank must be increased for the deposits in transit and reduced by the outstanding checks. The balance per books must be adjusted for any actual transactions not yet recorded.

The bank reconciliation is prepared by carefully analyzing the bank statement and the related general ledger account or check register. Exhibits 4.2 and 4.3 show the documents corresponding to the preceding reconciliation. To identify all relevant items needed for the reconciliation, you must take time to carefully study these documents. You will also observe that the bank statement includes a few irrelevant checks (like checks no. 448 and 449, probably written in a prior month and shown as outstanding in last month's reconciliation) and deposits ($3,821.13, probably recorded in the prior month and shown as in transit in last month's reconciliation). Sometimes tracking down all the reconciling items can be a painstaking process, but it is an essential tool for maintaining accurate records.

Exhibit 4.2: Bank statement

Santa Clara Bank						
This statement covers:						**Statement for:**
June 1, 20X5 through June 30, 20X5						Kaplan's Medical Clinic 21 East Main Santa Clara
Checking account # 4783080	**Monthly summary**					
	Previous statement balance on 5-31-X5					$ 17,375.76
	Total of 5 deposits for					21,935.98+
	Total of 12 withdrawals for					$ 22,385.99−
	Interest earnings for					28.15+
	Service charges for					75.00−
	New balance					$ 16,878.90
Checks and other debits	**Check**	**Date paid**	**Amount**	**Check**	**Date paid**	**Amount**
	448	3–Jun	2,134.67	454	15–Jun	$ 1,313.13
	449	5–Jun	256.09	455	17–Jun	645.38
	450	9–Jun	3,334.55	456	23–Jun	1,788.07
	452	9–Jun	24.56	457	27–Jun	4,610.00
	453	12–Jun	7,112.54	*460*	30–Jun	349.44
	Electronic funds transfer − Ready Electric				25–Jun	376.56
	NSF refund check				27–Jun	441.00
	Monthly service fee				30–Jun	75.00
Deposits and other credits					**Date**	**Amount**
	Patient deposit				1–Jun	$ 3,821.13
	Patient deposit				5–Jun	3,750.00
	Collection item − note receivable ($1,000 + interest)				12–Jun	1,060.00
	Patient deposit				15–Jun	11,524.78
	Credit card sales posting				28–Jun	1,777.07
	Interest earnings				30–Jun	28.15

Exhibit 4.3: General ledger account

Date	Patient	Ref#	Check	Deposit	Balance
1 –Jun		Balance			$18,806.13
4–Jun	Deposit		–	$ 3,750.00	22,556.13
7–Jun	Valequez	450	$ 3,334.55	–	19,221.58
8–Jun	Nicole	451	106.15	–	19,115.43
8–Jun	Smith	452	24.56	–	19,090.87
10–Jun	Zhao	453	7,112.54	–	11,978.33
15–Jun	Rollin	454	1,313.13	–	10,665.20
15–Jun	Deposit		–	11,527.78	22,192.98
16–Jun	LeBeau	455	654.38	–	21,547.60
20–Jun	Pechlat	456	1,788.07	–	19,759.53
23–Jun	Valequez	457	4,610.00	–	15,149.53
26–Jun	Goodman	458	2,256.12	–	12,893.41
28–Jun	Hanks	459	3,000.00	–	9,893.41
29–Jun	Anderson	460	349.44	–	9,543.97
	Deposit		–	9,443.12	18,987.09
			$24,539.94	$24,720.90	

Referring back to Exhibit 4.1, the company's records show only $18,987.09 in cash, but the correct balance is $20,959.75, so cash must be increased by a total of $1,972.66 ($20,959.75 − $18,987.09). The following journal entries record this increase, along with other debits and credits necessary to record the previously unrecorded transactions. Carefully note how each entry corresponds to one of the reconciling items.

6-30-X5	Cash	1,060.00	
	Notes receivable		1,000.00
	Interest income		60.00
	To record proceeds of note collected by bank on behalf of the company		

6-30-X5	Cash	1,777.07	
	Sales		1,777.07
	To record credit card sales for transactions posted directly to company bank account		

6-30-X5	Cash	28.15	
	Interest income		28.15
	To record interest income earned on bank account		

6-30-X5	Miscellaneous expense	75.00	
	Cash		75.00
	To record adjustment for bank service charge automatically charged against company bank account		

6-30-X5	Utilities expense	376.56	
	Cash		376.56
	To record adjustment for utility bill automatically charged against company bank account		

6-30-X5	Accounts receivable	441.00	
	Cash		441.00
	To record adjustment for returned (NSF) patient check; the intent will be to collect this amount from the patient		

The net effect of the preceding entries is to increase the Cash account by $1,972.66. The T-account (Exhibit 4.4) shows this impact.

Exhibit 4.4: A T-account for Cash

Cash

Dr.	Cr.
$1,060.00	$ 75.00
1,777.07	376.56
28.15	441.00
$2,865.22	$892.56
1,972.66	

In lieu of multiple separate entries as shown, companies might instead prepare a compound journal as follows:

6-30-X5	Cash	1,972.66	
	Utilities expense	376.56	
	Accounts receivable	441.00	
	Miscellaneous expense	75.00	
	Notes receivable		1,000.00
	Sales		1,777.07
	Interest income		88.15
	To record adjustments necessitated by bank reconciliation		

When preparing a compound journal entry, it is always a good idea to total both the debit and credit columns to be sure they are equal. In the example above, both equal $2,865.22. If the journal entry is not equal, then the books will not balance at the end of the accounting period. You would need to figure out why the entry doesn't balance before posting it to the General Ledger. Often errors happen when a number is listed incorrectly or omitted.

4.3 Petty Cash Funds

Petty cash funds are in frequent use for making small payments that may be impractical to pay by check or credit card. Examples include postage, employee reimbursements, office supplies, snacks, and similar immaterial expenditures. A petty cash fund is primarily a tool of convenience, not necessity. A petty cash fund is established by making out a check to "Cash," cashing it, and placing the cash in a petty cash box under the control of a designated custodian. The following entry would be used to initially establish a $500 petty cash fund:

3-15-X4	Petty cash	500.00	
	Cash		500.00
	To establish a $500 petty cash fund		

Policies should establish the types and amounts of expenditures that can be paid from petty cash. When a disbursement is made from the fund, a receipt (a petty cash voucher) is placed in the petty cash box. Thus, the sum of the receipts plus the remaining cash should always equal the balance of the petty cash fund. As cash becomes depleted, another check payable to "Cash" is prepared in an amount to bring the fund back up to the desired balance. That check is cashed and the proceeds are placed in the petty cash box. Simultaneously, receipts are removed from the petty cash box and formally recorded as expenses. The appropriate journal entry is to debit the appropriate expense accounts based on the receipts and to credit Cash.

3-31-X4	Supplies expense	225.00	
	Fuel expense	50.00	
	Miscellaneous expense	75.00	
	Cash		350.00
	To replenish petty cash; receipts on hand of $350 for supplies, fuel, and snacks		

Take note that the preceding entry did not impact the Petty Cash account. The balance of Petty Cash remains at $500.

On occasion, the petty cash on hand may not exactly match what should be found in the box. Errors can occur, and the actual cash on hand plus receipts may differ from the official petty cash balance. Assume the preceding facts, except that only $125 of cash was actually in the box. Thus, $375 is needed to replenish the fund, as follows:

3-31-X4	Supplies expense	225.00	
	Fuel expense	50.00	
	Miscellaneous expense	75.00	
	Cash short	25.00	
	Cash		375.00
	To replenish petty cash; receipts on hand of $350 for supplies, fuel, and snacks and $25 for cash shortage		

The Cash Short account is like an expense, and it reflects the missing $25. Hopefully, this will not be a common occurrence.

If a company subsequently increases petty cash, the following entry would be necessary:

3-15-X4	Petty cash	250.00	
	Cash		250.00
	To increase petty cash fund by $250		

Notice that the preceding entry is identical to that recorded to establish a petty cash fund.

4.4 Accounts Receivable

You already know that receivables arise from a variety of claims against patients and insurers. Payments in a healthcare entity can be extremely complex. Unlike most businesses, third parties pay a majority of the costs for health care. These can include insurance companies, governmental agencies, or other third-party payers. The patient often gets caught in the middle when healthcare facilities are trying to collect the money due in accounts receivable.

The payment system for each healthcare institution is different and depends on the contract rates set sometimes with hundreds of potential payers. Most healthcare providers establish rates for their services called **charges**. These charges may not match the actual rates negotiated with each insurer or with the government for Medicare or Medicaid payments. Any difference between the charge and the negotiated rate is called the **contractual allowance**. Sometimes the patient pays the bill in full and then submits the bill to his or her insurer for payment, but more often the patient will pay only their co-payment and deductible. The healthcare facility will then need to bill the insurer or the government for the remainder due. The amount not received in cash would then be added to the Accounts Receivable account.

For example, suppose Mary Smith received services for which Kaplan's Medical Clinic charges $1,500. The contractual allowance for this type of service negotiated with the insurer is $500, so the net charge is $1,000. Mary's co-payment is 20%, or $200. She has already met her deductible for the year. The insurer will need to be billed for $800. This transaction will be entered in the books in this way:

6-15-X4	Cash	200.00	
	Accounts receivable	800.00	
	Contractual allowance	500.00	
	Revenue		1,500.00

If Mary Smith had not met her deductible, she would have paid more in cash, and the insurer would have been billed for less. Most healthcare providers today require payment at the time of service from the patient. In a hospital or outpatient surgery facility, where payments can run into thousands of dollars, the entity may allow patients to set up an account to pay off their portion of the charges at an agreed-upon monthly amount. This is essentially a loan or note. In these healthcare environments you may also see an account called Accounts Receivable–Notes or Notes Receivable to track patient's long-term payments due.

Things can be even more complicated in a healthcare setting because not everyone pays the same amount for the same service. For example, if Jack Smith is a Medicare patient, the contractual allowance may be $700. If Harry Smith is a Medicaid patient, the contractual allowance may be $750. If Betty Smith is a private payer, there may be no contractual allowance. If Sandy Smith is a managed care patient, reimbursement could be a flat fee arrangement, with Sandy paying $100 and the insurer paying $700. Table 4.3 shows you how these different payment arrangements would look.

Table 4.3: Differences in patient payments

	Mary Smith Traditional Fee-for-Service	Jack Smith Medicare	Harry Smith Medicaid	Betty Smith Private Pay	Sandy Smith Managed Care
Provider charge	$1,500	$1,500	$1,500	$1,500	$1,500
Contractual allowance	$ 500	$ 700	$ 750	$ 0	$ 700
Net charge	$1,000	$ 800	$ 750	$1,500	$ 800
Patient co-pay	20%	20%	0%	100%	Flat fee of $ 100
Patient payment	$ 200	$ 160	$ 0	$1,500	$ 100
Insurance payment	$ 800	$ 640	$ 750	$ 0	$ 700
Total received by provider for care	$1,000	$ 800	$ 750	$1,500	$ 800

As you can see in Table 4.3, reimbursements for patient care can vary significantly depending upon who the insurer is for the patient. This example showed reimbursement for one treatment. Sometimes a treatment will require numerous procedures at the same time. The key for provider reimbursement is how the provider codes the treatment. Coding medical bills is a specialty, and many providers hire people who understand how to code bills to get the greatest reimbursements. Many large clinics hire specialists who code bills within each medical specialty to be certain that bills are coded properly. Proper coding enables healthcare organizations to get the highest possible levels of reimbursement.

As a manager or decision maker in a healthcare environment, you will need to be certain your billing is coded correctly. Keeping a close eye on your charges versus your actual payments is a critical function to ensure that your department or division is profitable. You will likely get an internal report from your accounting department with this detail. Watch your payment trends closely and question any changes that reduce your actual reimbursements.

Most receivables are trade receivables originating from services to patients. Trade receivables are accounted for via the Accounts Receivable account. Generally, a patient will pay their co-payment at the time of service, and the insurer will be billed for the rest of the payment due. Other nontrade receivables can originate from loans to employees, deposits left with others, and so forth, but they are rare in most healthcare organizations. These will likely only be found in large for-profit hospital or clinics, if they are found at all.

Occasionally healthcare facilities will agree to provide credit to patients for major medical procedures. By providing services on credit to a patient, a company also assumes certain costs and risks. Companies must be careful when trading services for a future payment. On occasion, a patient may not pay, and this can result in a substantial loss. Credit providers must investigate a patient's credit history and expend considerable effort on billing and collection activities. Furthermore, the creditor temporarily forgoes use of funds while waiting for payment.

You may wonder why anyone would bother to extend credit, but there are certain advantages. For one thing, patients are sometimes more willing to agree to a treatment if they are afforded flexibility on payment terms. This can boost a company's overall revenue. Sometimes, credit terms may include interest charges. This provides an extra source of earnings for the medical facility.

4.5 Revenue Changes and Health Care Reform

There are still many unknowns about healthcare reform and how changes will impact the revenues of healthcare providers. This is definitely a moving target that you will need to follow in the news and in healthcare journals that focus on reimbursements. Bringing potential for big changes are Accountable Care Organizations (ACOs). These are new organizations being encouraged by the law in which healthcare providers form cooperative groupings to manage the care of patients and be responsible for the quality of that care. If an ACO could provide high-quality care at a lower cost to Medicare, then it would share in the savings with Medicare. This could possibly improve the revenue to the providers involved in the ACO.

An ACO may initially be costly to set up. Patient care protocols need to be developed, as do administrative procedures for patient care among the cooperating providers. Providers will also need to negotiate shared fees. It is envisioned that these ACOs will specialize in certain types of chronic illnesses, such as care for a patient with diabetes, kidney disease, or chronic heart conditions. How these ACOs will ultimately be accounted for in the accounting system still needs to be developed. Details will not be available until an ACO is actually organized, protocols are set up, and payment arrangements are negotiated.

In addition to the ACO structures, the law also provides for "bundled payments" as a potential way to reduce costs for Medicare. Hospitals, ACOs, or other providers may bid to Medicare for providing care to specific types of patients, such as patients who undergo transplant surgery, on a fee-for-care basis that amounts to a lump sum less than would be paid for this care on a fee-for-service basis. Medicare would save money, and providers would have the potential to make better profits with coordinated quality care.

4.6 Direct Write-Off Method

As noted, and unhappily so, some customers may never pay for the goods and services they have received. The provider should not carry the resulting Accounts Receivable on its balance sheet once it has become clear that it will not be paid. A simple process for accounting for uncollectible accounts is the **direct write-off method**. When an account is determined to be uncollectible, the following entry would be recorded:

3-20-X4	Uncollectible accounts expense	700.00	
	Accounts receivable		700.00
	To record the write-off of an uncollectible account		

Some companies use the term "bad-debt expense" to describe the cost of the uncollectible items. In 2011, accounting rules changed for healthcare organizations. Today, bad debt for healthcare organizations is shown as a deduction from revenue in a line item called "Allowance for Bad Debt."

Allowance Techniques for Uncollectible Accounts

Accountants have developed **allowance methods for uncollectibles**. These techniques result in the recording of estimates for bad-debt expenses in the same period as the related credit sales. Suppose that Allied Health Hospital has an Accounts Receivable balance of $500,000. It is estimated that 3%, or $15,000, of this total pool of accounts will ultimately prove to be uncollectible. The correct balance sheet presentation would be as follows:

Accounts receivable	$500,000
Less: Allowance for uncollectible accounts	(15,000)
	$485,000

Notice that the allowance account is presented as a Contra Asset account to the gross (total) amount of Accounts Receivable. The resulting $485,000 corresponds to the **net realizable value** of the receivables pool.

The allowance account to include on the balance sheet can be determined by various methods. In the given example, it was presumed that 3% of the outstanding Accounts Receivable balance was the appropriate level to establish. The actual rate will vary by company and, in each case, should be based on detailed analysis of outstanding receivables balances. This may entail an aging of accounts, which attempts to stratify the receivables according to how long they have been outstanding. There is a presumption that older accounts are more likely to be problematic and represent a higher risk of nonpayment. Whether determined by using a percentage of receivables, an aging, or another technique, the estimated amount for the allowance account must be established in the ledger.

Assume that Allied Health's ledger revealed an Allowance for Uncollectible Accounts credit balance of $5,000 (prior to calculating the $15,000 necessary balance). As a result, the following entry is needed to bring the accounts up to date:

12-31-X8	Uncollectible accounts expense	10,000.00	
	Allowance for uncollectible accounts		10,000.00
	To adjust the allowance account from a $5,000 balance to the desired balance of $15,000		

This approach is a **balance sheet approach**. That is, an assessment was made of the desired balance for the allowance that is to be reported on the balance sheet. The adjusting entry brought the allowance up to the targeted level. You should carefully note that the amount of the entry is based on the necessary change in the account.

There is a simpler **income statement approach**. An estimated percentage of total net charges (or charges on account) is debited to Uncollectible Accounts Expense and credited to the Allowance for Uncollectible Accounts. This method results in the addition of the estimated amount to the Allowance account. In other words, it incrementally adjusts the allowance account for a portion of each additional dollar of sales. Assume that Good Name Hospital had sales during the year of $1,000,000, and it estimates uncollectible accounts as accruing at the rate of 2% of total sales. Thus, the necessary entry would add $20,000 ($1,000,000 × 2%) to the allowance, regardless of the existing balance:

12-31-X8	Uncollectible accounts expense	20,000.00	
	Allowance for uncollectible accounts		20,000.00
	To add 2% of sales to the allowance account		

Any of the allowance methods are acceptable, provided the accountant concludes that they reasonably reflect the anticipated cost of uncollectible accounts and fairly present the balance sheet of the company.

Writing Off an Account Against an Allowance

We have now seen how to record uncollectible accounts expense and set up the related allowance. But how do we write off an individual account that is uncollectible? This part is easy. The following entry is used:

3-15-X9	Allowance for uncollectible accounts	5,000.00	
	Accounts receivable		5,000.00
	To record the write-off of an uncollectible account		

Notice that the entry reduces both the allowance account and the related receivable and has no impact on the income statement. Remember, under the allowance account, the income statement occurs when the allowance is set up (think matching principle), not when the account is actually written off against the previously established allowance. Because the write-off entry reduces both an asset and contra asset by similar amounts, there is no impact on the net realizable value of the receivables, total assets, or any other accounts.

Credit and Debit Card Transactions

Many providers will accept popular credit and debit cards such as MasterCard®, Visa®, and American Express®. The financial services companies offering these cards earn money by charging fees to the provider (such as 1.5% of the transaction amount). In addition, the credit card companies may also charge users service fees and interest. Although potentially expensive to providers and patients alike, the cards introduce convenience, stimulate spontaneous services, and usually assure collectability for the provider. Depending on the card and related agreement, providers may collect the patient co-payment on the day of service by electronic transfer of funds. This reduces the size of internal credit departments at many businesses and can accelerate a business's access to funds.

The accounting for credit and debit card payments depends somewhat on the terms of the card. For bank card–based transactions, funding usually occurs quickly. Therefore, the following entries may be appropriate in some cases.

1-9-X3	Cash	490.00	
	Service charge	10.00	
	Services		500.00
	Provided services for $500 via debit card with same-day funding, net of 2% fee		

If the card/debit payment involved delayed collection, the preceding debit to Cash would instead be reflected as a debit to Accounts Receivable.

Case Study: Happy Hospital

Frank Wright, the comptroller for the Happy Hospital, has been asked to determine how much of its debts are collectable and how much should be written off as noncollectable. The December 31, 20X2, year-end trial balance of Happy Hospital revealed the following account information:

	Debits	Credits
Accounts receivable	$252,000	
Allowance for uncollectible accounts		$ 3,000
Sales		855,000
Sales returns and allowances	12,900	
Sales discounts	8,100	

Wright decided it was best to analyze the potential write-offs using both the direct write-off method and the allowance method. In order to complete this task, he must do several different types of calculations. Complete the calculations to determine which method works best in property matching revenues and expenses.

Case Study Exercises

1. Determine the adjusting entry for bad debts under each of the following conditions:
   a. An aging schedule indicates that $12,420 of Accounts Receivable will be uncollectible.
   b. Uncollectible accounts are estimated at 2% of net sales.
2. On January 19, 20X3, Happy Hospital learned that Mary Smith, a customer, had declared bankruptcy. Present the proper entry to write off Mary Smith's $950 balance.
3. Repeat the requirement in part (b), using the direct write-off method.
4. In light of the Mary Smith bankruptcy, examine the allowance and direct write-off methods in terms of their ability to properly match revenues and expenses.

Key Terms

allowance methods for uncollectibles Techniques that result in the recording of estimates for bad-debts expense in the same period as the related credit sales.

balance sheet approach The approach in which an assessment was made of the desired balance for the allowance that is to be reported on the balance sheet.

bank reconciliation The process needed to identify errors, irregularities, and adjustments needed to the Cash account.

bank statement The document provided by the bank showing deposits, checks, other activity, and balances.

cash Currency, coins, bank demand deposits that can be freely withdrawn, undeposited checks from customers, and other items that are acceptable to a bank for deposit.

cash equivalents Sometimes included in reporting of cash, very short-term (usually interest-earning) financial instruments like government Treasury bills.

charges Rates for health services established by the healthcare facility.

contractual allowance The difference between the charge established and the negotiated rate with the insurer or government.

deposits in transit Receipts entered on company records but not processed by the bank.

direct write-off method A process for accounting for uncollectible accounts.

income statement approach A method that employs estimates of uncollectibles based on total sales or credit sales.

net realizable value The amount of cash expected from the collection of current customer balances.

NSF (nonsufficient funds) checks Checks that have been previously deposited but that have been returned for nonpayment.

outstanding checks Written checks that have not cleared the bank.

petty cash Funds used for making small payments that may be impractical to pay by check or credit card.

treasurer The person in a company whose job is to manage cash flows of the business.

Review Questions

The following questions relate to several issues raised in the chapter. Test your knowledge of the issues by selecting the best answer. (The odd-numbered answers appear in the appendix.)

1. Which of the following statements about the direct write-off method is false?
   a. The direct write-off method can result in recognizing sales revenue in one period and expense related to that revenue in a subsequent period.
   b. The write-off of a customer's account balance results in a debit to Uncollectible Accounts Expense.
   c. The Allowance for Uncollectibles account is not used when the direct write-off method is employed.
   d. Sales are essentially recognized by the cash basis of accounting when the direct write-off method is used.

2. The income statement and balance sheet approaches are used to estimate uncollectible accounts. Which of the following comments applies to both of these approaches?
   a. The aging process is often used to obtain proper valuation amounts.
   b. Generally speaking, matching is improved when compared with the direct write-off method.
   c. The focus is on the net realizable value of accounts receivable.
   d. Total credit sales is commonly used as the estimation base.
3. Allied Health Systems estimates uncollectible accounts at 5% of ending accounts receivable. The company's records reveal ending receivables of $2,000,000 and a $40,000 debit balance in the Allowance for Uncollectibles. How much would Allied's year-end adjusting entry for bad debts increase the ending balance in its Uncollectible Accounts Expense?
   a. $40,000
   b. $60,000
   c. $100,000
   d. $140,000
4. Kaplan's Medical Clinic uses the allowance method of accounting for bad debts. The company recently wrote off the $135 balance of Karen Sorrell as uncollectible. As a result of the write-off, Kaplan's Medical Clinic will experience
   a. a $135 decline in income.
   b. a $135 decline in the net realizable value of Accounts Receivable.
   c. a $135 increase in the Allowance for Uncollectible Accounts.
   d. no change in total assets.
5. The collection of an account previously written off under the allowance method will involve two separate journal entries. After both of these entries are recorded,
   a. total accounts receivable will be unchanged.
   b. the Allowance for Uncollectibles Accounts will decrease.
   c. uncollectible accounts expense will increase.
   d. uncollectible accounts expense will decrease.
6. What items are normally included in the Cash account on the balance sheet?
7. What is cash management? Briefly discuss the planning and control aspects of an effective cash management system.
8. What is a bank reconciliation?
9. What is the effect of a bank debit memo on a depositor's account balance?
10. What are the reasons for the discrepancy between the cash balance reported on the bank statement and the cash balance in the accounting records?
11. Briefly describe the two methods that can be used to record losses from uncollectible accounts.

Exercises

1. **Bank reconciliations: missing amounts**. The following independent cases relate to bank reconciliations. Compute the missing amounts, assuming that no other reconciling items exist.

	Case A	Case B	Case C
Balance per bank	$6,000	$4,000	$?
Outstanding checks	500	2,100	1,400
Deposits in transit	2,000	?	1,000
Balance per company records	?	8,000	450

2. **Items on a bank reconciliation**. You are preparing the June bank reconciliation for Advanced Systems. Identify the proper placement of parts (a)–(f) on the reconciliation by using the following codes:

   1—An addition to the balance per bank as of June 30

   2—A deduction from the balance per bank as of June 30

   3—An addition to the balance per company records as of June 30

   4—A deduction from the balance per company records as of June 30

   _____ a. Interest earned on the account during June
   _____ b. A company deposit taken to the bank at 3:00 p.m. on June 30 but not recorded on the June bank statement
   _____ c. A $3,000 deposit, entered in the company records as $300
   _____ d. A deposit of Allied Health Systems, incorrectly credited to Allied Health Systems's account receivables account
   _____ e. A customer's check returned for nonsufficient funds
   _____ f. Check no. 765, which has not yet cleared the bank

3. **Bank reconciliation and entries**. The following information was taken from the accounting records of Palmetto Clinic for the month of January:

Balance per bank	$6,150
Balance per company records	3,580
Bank service charge for January	20
Deposits in transit	940
Interest on note collected by bank	100
Note collected by bank	1,000
NSF check returned by the bank with the bank statement	650
Outstanding checks	3,080

a. Prepare Palmetto's January bank reconciliation.
b. Prepare any necessary journal entries for Palmetto.

4. **Accounting for cash**. Evaluate the following comments as true or false. If the comment is false, briefly explain why.

   a. A petty cash fund should be replenished at the conclusion of an accounting period.
   b. A journal entry is needed in a company's accounting records to record both a bank service charge and the firm's outstanding checks.
   c. As shown on May's bank statement, the Nebraska National Bank incorrectly deducted $200 from the account of Millar's Medical. When preparing its bank reconciliation, Millar's should subtract $200 from the accounting records so that the adjusted cash balance (company records) will equal the adjusted cash balance (bank).
   d. Customer checks, money orders, and certificates of deposit are properly classified as cash on the balance sheet.
   e. To achieve strong internal control, a store cashier should have access to a company's accounting records for cash.

5. **Direct write-off method**. Allied Health Clinic, which began business in early 20X7, reported $40,000 of accounts receivable on the December 31, 20X7, balance sheet. Included in this amount was a $550 claim against Tom Mattingly from services in July. On January 4, 20X8, the company learned that Mattingly had filed for personal bankruptcy. Allied Health Clinic uses the direct write-off method to account for uncollectibles.

   a. Prepare the journal entry needed to write off Mattingly's account.
   b. Comment on the ability of the direct write-off method to value receivables on the year-end balance sheet.

Problems

1. **Direct write-off and allowance methods: matching approach**. The December 31, 20X2, year-end trial balance of Happy Hospital revealed the following account information:

	Debits	**Credits**
Accounts Receivable	$252,000	
Allowance for Uncollectible Accounts		$ 3,000
Sales		855,000
Sales Returns and Allowances	12,900	
Sales Discounts	8,100	

Instructions

a. Determine the adjusting entry for bad debts under each of the following conditions:

   (1) An aging schedule indicates that $12,420 of accounts receivable will be uncollectible.
   (2) Uncollectible accounts are estimated at 2% of net sales.

b. On January 19, 20X3, Happy Hospital learned that Mary Smith, a customer, had declared bankruptcy. Present the proper entry to write off Mary Smith's $950 balance.
c. Repeat the requirement in part (b), using the direct write-off method.
d. In light of the Mary Smith bankruptcy, examine the allowance and direct write-off methods in terms of their ability to properly match revenues and expenses.

2. **Allowance method: income statement and balance sheet approaches**. Carson Clinic reported accounts receivable of $300,000 and an allowance for uncollectible accounts of $31,000 (credit) on the December 31, 20X2, balance sheet. The following data pertain to 20X3 activities and operations:

Sales on account	$2,000,000
Cash collections from credit customers	1,600,000
Sales discounts	50,000
Sales returns and allowances	100,000
Uncollectible accounts written off	29,000
Collections on accounts that were previously written off	2,700

Instructions

a. Prepare journal entries to record the sales-related and receivables-related transactions from 20X3.
b. Prepare the December 31, 20X3, adjusting entry for uncollectible accounts, assuming that uncollectibles are estimated to be 2% of net credit sales.
c. Prepare the December 31, 20X3, adjusting entry for uncollectible accounts, assuming that uncollectibles are estimated at 1% of year-end accounts receivable.
d. Compute the amount of the adjusting entry in part (c), assuming that $46,000, rather than $29,000, of accounts were written off in 20X3.