

chapter 4

Cash, Receivables, and Controls



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Learning Goals

- Define cash and cash equivalents.
- Know 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.
- Master basic calculations and accounting techniques for notes receivable.

Chapter Outline

4.1 Concepts of Cash

Cash Management and Control

4.2 Bank Reconciliations

4.3 Petty Cash Funds

4.4 Accounts Receivable

4.5 Direct Write-Off Method

Allowance Techniques for Uncollectible Accounts

Writing Off an Account Against an Allowance

Formalized Receivables and Notes

Credit and Debit Card Transactions

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Cash includes currency, coins, bank demand deposits that can be freely withdrawn, undeposited checks from customers, and other items that are acceptable to a bank for deposit.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 latter 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 a 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)
- 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 receipt occurs at the point of sale or collection to deposit at the bank. 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
Use point-of-sale terminals to record cash transactions.
Daily, compare cash to register tapes.
Daily, deposit cash 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.
The person opening the mail immediately forwards all checks to the cashier for deposit.

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

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. 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** are checks previously deposited but 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 Winslow Quilts. 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. The following additional data and items of information are needed to prepare and explain the bank reconciliation:

Exhibit 4.1: Two statements for bank reconciliation for Winslow Quilts on June 30, 20X5

Winslow Quilts Bank Statement For the Month Ending June 30, 20X5		Winslow Quilts Records Statement For the Month Ending June 30, 20X5	
Ending balance per bank statement	\$ 16,878.90	Ending balance per company records	\$ 18,987.09
Add:		Add:	
Deposits in transit	9,443.12	Note and interest collected	\$ 1,060.00
Deduct:		Credit card postings	1,777.07
Outstanding checks		Interest earnings	28.15
#451	\$ 106.15		2,865.22
#458	2,256.12	Deduct:	
#459	3,000.00	Service charges	\$ 75.00
	(5,362.27)	Electric bill ETF	376.56
Correct cash balance	\$ 20,959.75	NSF Check	441.00
			(892.56)
		Correct cash balance	\$ 20,959.75

- 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., quilts sold by accepting customer credit cards 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 (\$3,824.13, 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: June 1, 20X5 through June 30, 20X5			Statement for: Winslow Quilts 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					21,932.98 +
	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	2134.67	454	15–Jun	1313.13
	449	5–Jun	256.09	455	17–Jun	645.38
	450	9–Jun	3334.55	456	23–Jun	1788.07
	452	9–Jun	24.56	457	27–Jun	4610.00
	453	12–Jun	7112.54	*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
	Customer deposit			1–Jun		3824.13
	Customer deposit			5–Jun		3750.00
	Collection item – note receivable (\$1,000 + interest)			12–Jun		1060.00
	Customer deposit			15–Jun		11524.78
	Credit card sales posting			28–Jun		1777.07
	Interest earnings			30–Jun		28.15

Exhibit 4.3: General ledger account

<i>Cash</i>	
<i>Dr.</i>	<i>Cr.</i>
1,060.00	75.00
1,777.07	376.56
28.15	441.00
<u>2,865.22</u>	<u>892.56</u>
1,972.66	

Because the company's records show only \$18,987.09 in cash, but the correct balance is \$20,959.75, 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
	<i>To record proceeds of note collected by bank on behalf of the company</i>		

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

6-30-X5	Cash	28.15	
	Interest Income		28.15
	<i>To record interest income earned on bank account</i>		

6-30-X5	Miscellaneous Expense	75.00	
	Cash		75.00
	<i>To record adjustment for bank service charge automatically charged against company bank account</i>		

6-30-X5	Utilities Expense	376.56	
	Cash		376.56
	<i>To record adjustment for utility bill automatically charged against company bank account</i>		

6-30-X5	Accounts Receivable	441.00	
	Cash		441.00
	<i>To record adjustment for returned (NSF) customer check; the intent will be to collect this amount from the customer</i>		

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

Date	Party	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	645.38	–	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
			<u>\$ 24,539.94</u>	<u>\$ 24,720.90</u>	

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 (60 + 28.15)		88.15
	<i>To record adjustments necessitated by bank reconciliation</i>		

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
	<i>To establish a \$500 petty cash fund</i>		

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
	<i>To replenish petty cash; receipts on hand of \$350 for supplies, fuel, and snacks</i>		

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
	<i>To replenish petty cash; receipts on hand of \$350 for supplies, fuel, and snacks and \$25 for cash shortage</i>		

The Cash Short account is like an expense and 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	500.00	
	Cash		500.00
	<i>To increase petty cash fund by \$250</i>		

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 customers and others. Most receivables are trade receivables originating from the sale of products or services to customers. Trade receivables are accounted for via the Accounts Receivable account. Other nontrade receivables can originate from loans to employees, deposits left with others, and so forth. Some nontrade receivables may be shown as noncurrent if there is an expectation that they are not going to be converted back into cash during the current cycle.

By selling on credit, a company also assumes certain costs and risks. Companies must be careful when trading goods and services for a future payment. On occasion a customer may not pay, and this can result in a substantial loss. Credit providers must investigate a customer'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, customers are sometimes more willing to buy if they are afforded flexibility on payment terms. This can boost a company's overall sales. Sometimes, credit terms may include interest charges. This provides an extra source of earnings for the seller. Indeed, some businesses make as much or more money on interest charges as they do on the margin of the product sold.

4.5 Direct Write-Off Method

As noted, unhappily so, some customers may never pay for the goods and services they have received. The seller 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
	<i>To record the write-off of an uncollectible account</i>		

Some companies use the term bad-debt expense to describe the cost of the uncollectible items. The entry causes an increase in Expense and a reduction in the Accounts Receivable balance. The problem with this approach is that it causes a poor matching of revenues and expenses. Notice that the Uncollectible Accounts Expense might not be recorded until one or more periods subsequent to the period of recording the sale (and setting up the receivable). Although the direct write-off method might be used in cases where uncollectibles are not material in amount (and for tax purposes, as generally required under U.S. tax statutes), it is not permissible for use under generally accepted accounting principles. The mismatching problem is deemed sufficiently bad that accountants have come up with an alternative.

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 Marquez Company 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	<u>(15,000)</u>
	<u>\$485,000</u>

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 Marquez'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
	<i>To adjust the allowance account from a \$5,000 balance to the desired balance of \$15,000</i>		

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 sales (or sales 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 Zhu Hai Company 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 ($\$1,000,000 \times 2\%$) to the allowance, regardless of the existing balance:

12-31-X8	Uncollectible Accounts Expense	20,000.00	
	Allowance for Uncollectible Accounts		20,000.00
	<i>To add 2% of sales to the allowance account</i>		

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
	<i>To record the write-off of an uncollectible account</i>		

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 . . .), 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.

Formalized Receivables and Notes

Longer-term receivables are sometimes supported by a formal written promise or agreement. These **notes receivable** often entail interest charges. The **maker** of the note is the party promising to make payment, and the **payee** is the party to whom payment will be

made. The **principal** amount of the note is the stated value. The **maturity date** is the day the note is set to be paid. **Interest** is the charge for the use of money. The amount of interest is calculated as $\text{Principal} \times \text{Rate} \times \text{Time}$. Accountants must understand these terms and concepts to be able to calculate interest and prepare appropriate related entries.

A \$100,000, 90-day note, bearing interest at 6% per year, would produce total interest of \$1,500 [$\$100,000 \times 6\% \times (90 \div 360)$]. Notice that the time portion of the calculation is a proportion of a year. Here, for simplicity of illustration, we assume a 90-day note, out of a 360-day year. A more correct mathematical calculation of time would be $90 \div 365$. Sometimes notes are based on the 360-day year, perhaps for ease of calculation or because it results in a higher amount of interest. If you are a borrower, you should understand the terms on which interest charges are to be calculated (and you should prefer that the calculations be based on 365-day year).

The following entries show the issuance of the note and subsequent collection with interest.

1-1-X6	Notes Receivable	100,000.00	
	Sales		100,000.00
	<i>To record sale in exchange for formal note receivable</i>		
3-31-X8	Cash	101,500.00	
	Interest Income		1,500.00
	Notes Receivable		100,000.00
	<i>To record collection of note receivable plus accrued interest of \$1,500</i>		

If the note receivable were outstanding at the end of an accounting period, the accounting department would want to be certain to accrue interest income for amounts earned but not yet collected. You learned about these types of accruals in Chapter 3.

Credit and Debit Card Transactions

Many merchants 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 merchant (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 merchants and consumers alike, the cards introduce convenience, stimulate spontaneous sales, and usually assure collectability for the merchant. Depending on the card and related agreement, merchants may collect the sales price on the day of sale by electronic transfer of funds. This eliminates the need for internal credit departments at many businesses and can accelerate a business's access to funds.

The accounting for credit and debit card sales 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	
	Sales		500.00
	<i>Sold merchandise for \$500 via debit card with same-day funding, net of 2% fee</i>		

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

Concept Check

The following questions relate to several issues raised in the chapter. Test your knowledge of the issues by selecting the best answer. (The answers appear on p. 235.)

- Which of the following statements about the direct write-off method is false?
 - The direct write-off method can result in recognizing sales revenue in one period and expense related to that revenue in a subsequent period.
 - The write-off of a customer's account balance results in a debit to Uncollectible Accounts Expense.
 - The Allowance for Uncollectibles account is not used when the direct write-off method is employed.
 - Sales are essentially recognized by the cash basis of accounting when the direct write-off method is used.
- The income statement and balance sheet approaches are used to estimate uncollectible accounts. Which of the following comments applies to both of these approaches?
 - The aging process is often used to obtain proper valuation amounts.
 - Generally speaking, matching is improved when compared with the direct write-off method.
 - The focus is on the net realizable value of accounts receivable.
 - Total credit sales is commonly used as the estimation base.
- Gonzo Company 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 Gonzo's year-end adjusting entry for bad debts increase its Uncollectible Accounts Expense?
 - \$ 40,000
 - \$ 60,000
 - \$100,000
 - \$140,000
- The following information pertains to Laser Company:
 - Accounts receivable total is \$100,000, subdivided as follows: 50% are current; 30% are slightly past due; and 20% are long past due.

- Uncollectibles are current accounts, 5%; slightly past-due accounts, 25%; and long past-due accounts, 70%.
- The balance in the Allowance for Uncollectibles prior to adjustment is \$24,000, credit.

If Laser uses the aging approach to estimate bad debts, what is the balance in the Allowance for Uncollectibles account after adjustment?

- a. \$ 0
 - b. \$24,000
 - c. \$48,000
 - d. Some amount other than those above
5. Find-a-Friend Pet Shop 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, Find-a-Friend 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.
6. 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 account will decrease.
 - c. uncollectible accounts expense will increase.
 - d. uncollectible accounts expense will decrease.
7. What is the maturity value of a \$30,000, 8% note receivable, dated December 1, 20X2, and maturing on March 31, 20X3?
- a. \$30,000
 - b. \$30,200
 - c. \$30,800
 - d. \$32,400
8. The following facts pertain to a note receivable that was discounted at a local bank on December 1, 20X1:
- | | |
|--------------------------------|--------------------|
| Face amount: \$100,000 | Term: 60 days |
| Interest rate: 12% | Discount rate: 15% |
| Date of note: November 1, 20X1 | |

What is the interest revenue that would be recognized at the time of discounting?

- a. \$ 0
- b. \$ 725
- c. \$1,250
- d. \$1,275

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.

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.

interest The charge for the use of money.

maker The party promising to make payment on a note.

maturity date The day a note is set to be paid.

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

note receivable A written promise or agreement that sometimes supports longer-term receivables agreement.

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

outstanding checks Written checks that have not cleared the bank.

payee The party to whom payment will be made.

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

principal The amount of the note is the stated value.

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

Critical Thinking Questions

1. What items are normally included in the Cash account on the balance sheet?
2. Define the following items and describe how they are classified on the balance sheet:
 - a. Certificate of deposit
 - b. Postdated check
 - c. IOU
 - d. Travel advance
3. What is cash management? Briefly discuss the planning and control aspects of an effective cash management system.
4. What is a bank reconciliation?
5. What is the effect of a bank debit memo on a depositor's account balance?
6. What are the reasons for the discrepancy between the cash balance reported on the bank statement and the cash balance in the accounting records?
7. Distinguish between trade and nontrade receivables. Give three examples of the latter.
8. Explain why uncollectible accounts have both income statement and balance sheet implications for accountants.
9. Briefly describe the two methods that can be used to record losses from uncollectible accounts.
10. Discuss some possible deficiencies of the direct write-off method of 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 Advanced Design Systems, incorrectly credited to Advanced Systems' 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 Company 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 Kay's Auto Parts. When preparing its bank reconciliation, Kay'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.** Harrisburg Company, 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 a sale made in July. On January 4, 20X8, the company learned that Mattingly had filed for personal bankruptcy. Harrisburg 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.
6. **Allowance method: estimation and balance sheet disclosure.** The following pre-adjusted information for the Maverick Company is available on December 31:

Accounts receivable	\$107,000
Allowance for uncollectible accounts	5,400 (credit balance)
Credit sales	250,000

- a. Prepare the journal entries necessary to record Maverick's uncollectible accounts expense under each of the following assumptions:
- (1) Uncollectible accounts are estimated to be 5% of Credit Sales.
 - (2) Uncollectible accounts are estimated to be 14% of Accounts Receivable.
- b. How would Maverick's Accounts Receivable appear on the December 31 balance sheet under assumption (1) of part (a)?
- c. How would Maverick's Accounts Receivable appear on the December 31 balance sheet under assumption (2) of part (a)?

Problems

1. **Direct write-off and allowance methods: matching approach.** The December 31, 20X2, year-end trial balance of Targa Company 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, Targa learned that House Company, a customer, had declared bankruptcy. Present the proper entry to write off House's \$950 balance.
- c. Repeat the requirement in part (b), using the direct write-off method.
- d. In light of the House 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.** Tempe Company 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

- Prepare journal entries to record the sales- and receivables-related transactions from 20X3.
 - Prepare the December 31, 20X3, adjusting entry for uncollectible accounts, assuming that uncollectibles are estimated to be 2% of net credit sales.
 - Prepare the December 31, 20X3, adjusting entry for uncollectible accounts, assuming that uncollectibles are estimated at 1% of year-end accounts receivable.
 - 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.
3. **Allowance method: analysis of receivables.** At a January 20X2 meeting, the president of Sonic Sound directed the sales staff "to move some product this year." The president noted that the credit evaluation department was being disbanded because it had restricted the company's growth. Credit decisions would now be made by the sales staff.

By the end of the year, Sonic had generated significant gains in sales, and the president was very pleased. The following data were provided by the accounting department:

	20X2	20X1
Sales	\$23,987,000	\$8,423,000
Accounts Receivable, 12/31	12,444,000	1,056,000
Allowance for Uncollectible Accounts, 12/31	?	23,000 cr.

The \$12,444,000 receivables balance was aged as follows:

Age of Receivable	Amount	Percentage of Accounts Expected to Be Collected
Under 31 days	\$5,321,000	99%
31–60 days	3,890,000	90
61–90 days	1,067,000	80
Over 90 days	2,166,000	60

Assume that no accounts were written off during 20X2.

Instructions

- Estimate the amount of Uncollectible Accounts as of December 31, 20X2.
- What is the company's Uncollectible Accounts expense for 20X2?
- Compute the net realizable value of Accounts Receivable at the end of 20X1 and 20X2.
- Compute the net realizable value at the end of 20X1 and 20X2 as a percentage of respective year-end receivables balances. Analyze your findings and comment on the president's decision to close the credit evaluation department.

