

CH 7: CASH AND RECEIVABLES

UNDERSTANDING CASH & ACCOUNTS RECEIVABLE

- Managing & controlling cash & accounts receivable are critical objectives for many companies
- Key concerns relating to mgmt. & control of **cash** include:
 - o Implementing appropriate internal controls, including regular bank reconciliations
 - o Minimizing “idle” cash
- Key concerns relating to mgmt. & control of **accounts receivable** include:
 - o Implementing appropriate internal controls, including appropriate credit policies
 - o Speeding up the collection cycle

FINANCIAL ASSET

“Any asset that is:

- (i) Cash;
- (ii) A contractual right to receive cash or another financial asset from another party;
- (iii) A contractual right to exchange financial instruments w/ another party under conditions that are potentially favourable to the entity; or
- (iv) An equity instrument of another entity”

WHAT IS CASH?

- Cash is reported as a **current asset** if it is readily available to pay current obligations & is free of restrictions
- Cash consists of coins, currency, available funds on deposit at the bank, & petty cash
- Also includes money orders, certified cheques, cashier’s cheques, personal cheques, bank drafts, & usually savings accounts
- Post-dated cheques, travel advances, & stamps on hand are **not** classified as cash

REPORTING OF CASH

- Reporting cash needs **special attention** in the case of the following:
 1. Restricted cash
 2. Cash in foreign currencies
 3. Bank overdrafts
 4. Cash equivalents

RESTRICTED CASH

- **Compensating balances:** minimum cash balances maintained by a corporation **in support** of existing borrowings

- These funds are **not** available for use by the corporation, but the bank can use the restricted cash
- Petty cash, special payroll, & dividend accounts are examples of cash set aside for a special purpose (usually not material)
- If the restricted cash balance is material, must be segregated from regular cash for reporting purposes
- Classified as **current** or **non-current assets** depending on date of availability or expected disbursement
- **Note disclosure** of restricted cash is required

FOREIGN CURRENCIES

- Amount held in foreign currencies is **reported in Canadian dollars** on the date of the SFP (i.e. balance sheet date)
- The **exchange rate** on the date of the **SFP** is used to translate foreign currencies into Canadian dollars
- If restrictions exist on the foreign funds, those funds are reported as restricted

BANK OVERDRAFTS

- Overdrafts represent cheques written in excess of the cash account balances
- Overdrafts are reported as **current liabilities** (often reported as accounts payable)
- In general, bank overdrafts **should not be offset** against the Cash account
- However, bank overdrafts may be offset against available cash in another account if both accounts are **at the same bank**

CASH EQUIVALENTS

- Defined as “ST, highly liquid investments that are readily convertible to known amounts of cash & which are subject to an insignificant risk of changes in value.”
- Original maturity is generally 3 months or less
- **Typical examples:** T-bills, money-market funds, commercial paper
- ASPE excludes equity securities
- Under IFRS, some equity instruments can be classified as cash equivalents (for ex, preferred shares acquired w/in a short time of their maturity date)
- Cash equivalents are reported at **FV**

RECEIVABLES: INTRODUCTION

- Loans & receivables are specific claims against customers & other parties for cash (or other assets)
- Receivables are classified as either current (ST) or non-current (LT)

- Classified as **current receivables** if there is the **expectations to collect w/in 1 year** or operating cycle (whoever is longer)
- Receivables can be classified as either **trade receivables** or **non-trade receivables**

ACCOUNTS RECEIVABLE: ISSUES

- **Trade receivables** include:
 - o **Accounts receivable** (verbal promise to pay, normally w/in 30 to 60 days)
 - o **Notes receivable** (written promises w/ specified terms, e.g. interest rate & due date)
- **Nontrade receivables** include the following:
 1. Advances to employees or other officers
 2. Delayed payment terms from a purchaser
 3. Receivables from the government (e.g. GST recoverable, income tax receivable)
 4. Dividends & interest receivable
 5. Amounts owing by insurance companies

ACCOUNTS RECEIVABLE: TRADE DISCOUNTS VS CASH DISCOUNTS

- **Trade discounts** are discounts given to customers often for different quantities purchased (often quoted as a percentage)
- Trade discounts are generally **not recorded**; the price charged (net of the discount) is recorded by the seller as a receivable & revenue
- **Cash discounts (or sales discounts)** encourage customers to pay faster; they are **recorded**
- Ex of cash discounts: 2/10; n/30; the customer will receive a 2% discount if payment made w/in 10 days & the gross amount of the invoice is due in 30 days

ACCOUNTS RECEIVABLES: RECORDING CASH DISCOUNTS

- 2 methods: gross method & net method
- **Gross method** records discounts when customers pay w/in discount period
 - o **"Sales Discounts"** are deducted from sales on the income statement
 - o Most common method
- **Net method** records accounts receivable net of the discount; discounts forfeited by customers are recorded when not taken
 - o Preferred method (theoretically) but rarely used
 - o **"Sales Discounts Forfeited"** is recorded as "Other revenue" if customer doesn't take the discount

EX OF GROSS METHOD

\$10,000 sales on credit (terms 2/10, n/30)

Dr. Accounts Receivable	10,000	
Cr. Sales Revenue		10,000

Customer **pays account w/in** discount period

Dr. Cash	9,800	
Dr. Sales Discounts	200	
Cr. Accounts Receivable		10,000

EX OF NET METHOD

\$10,000 sales on credit (terms 2/10, n/30)

Dr. Accounts Receivable	9,800	
Cr. Sales Revenue		9,800

Customer **pays account after** discount period

Dr. Cash		10,000
Cr. Sales Discounts Forfeited	200	
Cr. Accounts Receivable		9,800

IMPAIRMENT OF ACCOUNTS RECEIVABLE

- ST receivables are reported at their **NRV**
- The NRV is the net amount of cash **expected** to be collected, which is not necessarily the amount legally receivable
- **Calculated as:**
 - o Gross accounts receivable **less**
 - o Estimated uncollectible accounts & any returns, allowances, or cash discounts
- Loans & receivables are impaired if there is "**significant adverse change**" in expected configuration of cash flows (i.e. timing or amount)

ESTIMATING UNCOLLECTIBLE RECEIVABLES

THE ALLOWANCE METHOD

- Records estimated impairment to properly value accounts receivables, & record the bad debts as expense in the same accounting period as the sale (matching concept)
- Receivables are reported at their estimated NRV—i.e., net of an AFDA

ESTIMATING UNCOLLECTIBLE ACCOUNTS

- The estimate of uncollectible accounts may be based on:
 - o **Allowance Procedure Only:** mgmt. frequently analyses accounts receivable, estimates uncollectible amounts & adjusts the AFDA
 - o **Mix of Procedures:** initially may use **percentage of sales** (or net sales), but must still adjust at year-end to ensure that AFDA is appropriate

- Regardless of procedure used, net accounts receivable at year-end **must be reported at NRV** (key focus is on msmt of accounts receivable at NRV)

ALLOWANCE PROCEDURE ONLY

- Uses past collection experience to estimate uncollectible accounts
- Focus is to **report accounts receivable at NRV**
 - o Doesn't focus on matching bad debt expense to sales
- Any existing balance in AFDA is used to calculate the current year's bad debt expense

WILSON & CO – AGING SCHEDULE

Name of Customer	Balance Dec. 31	Age (number of days accounts are outstanding)			
		Under 60 days	61-90 days	91-120 days	Over 120 days
Atlantic Stainless Steel Corp	\$ 9,800	\$ 7,000	\$ 2,800		
Brockville Steel Company	34,000	34,000			
Cambridge Sheet & Tube Co.	4,500				\$ 4,500
Eastern Iron Works Ltd.	7,200	6,000		\$ 1,200	
Other individual customers	491,500	413,000	15,200	12,800	50,500
	<u>\$547,000</u>	<u>\$460,000</u>	<u>\$18,000</u>	<u>\$14,000</u>	<u>\$55,000</u>

STEP ① : CALCULATE THE IMPAIRMENT & BAD DEBT EXPENSE :

$$460\,000 \times 0.04 = \$18\,400$$

$$18\,000 \times 0.15 = 2\,700$$

$$14\,000 \times 0.2 = 2\,800$$

$$55\,000 \times 0.25 = 13\,750$$

\$37 650 Cr. → REQUIRED BAL IN ALLOWANCE

(800) Cr. → LESS: CURRENT BAL IN ALLOWANCE

36 850

→ WRITE DOWN AMOUNT FOR PERIOD

STEP ② : RECORD THE WRITE-DOWN FOR THE PERIOD :

BAD DEBT EXPENSE 36 850

 AFDA 36 850

MIX OF PROCEDURES

- Initial use of "percentage-of-sales" approach is based on the relationship b/w sales & bad debts
- **Matches** the estimated cost of bad debts to sales generated in the same accounting period
- Any existing balance in the balance sheet account (AFDA) is **initially ignored** when calculating the current period's bad debts expense
- Receivables are also reviewed at year-end to ensure that balance is appropriate, & adjustment to AFDA is made

MIX OF PROCEDURES: EX

- Dickrill Corp. reports the following balances for its first year of operations (2017):
 - o Net credit sales: \$400,000
- The company estimates bad debts at **2% of net credit sales**
- Determine estimated bad debts expense for 2017

STEP ①: ESTIMATE BAD DEBTS EXPENSE:

$$\$400,000 \times 2\% = \$8,000$$

STEP ②: RECORD BAD DEBT EXPENSE:

BAD DEBT EXPENSE	8000
AFDA	8000

STEP ③: AT YEAR-END IF MGMT DETERMINES THAT \$9900 WILL NOT BE COLLECTIBLE, & THAT BALANCE OF ALLOWANCE ACCOUNT BEFORE YEAR-END ADJUSTMENTS IS \$7500:

BAD DEBT EXP	2400
AFDA (9900-7500)	2400

BALANCE SHEET PRESENTATION

- ST accounts receivable are shown at their NRV as follows:

Accounts Receivable	\$xx
Less: AFDA	<u>xx</u>
NRV	<u><u>\$xx</u></u>

ALLOWANCE METHOD: WRITING OFF ACCOUNTS RECEIVABLE

- When a specific customer's account is determined to be uncollectible, the following entry is made:

Dr. AFDA	x	
	Cr. Accounts Receivable—specific customer	x

(For the amount to be written off)

- If payment is received after write-off of account, the account is reinstated & payment is recorded:

Dr. Accounts Receivable	Dr. Cash
Cr. AFDA	Cr. Accounts Receivable (for the amount collected)

DIRECT WRITE-OFF METHOD

- If uncollectible amounts are highly immaterial, the allowance method is sometimes not used
- Instead, direct-write-off method may be used
- Record bad debt expense only when specific account is determined to be uncollectible:

Dr. Bad Debt Expense
Cr. Accounts Receivable

- No allowance account is used

RECOGNITION OF ST NOTES RECEIVABLE

- Notes receivable differ from accounts receivable as they are supported by a promissory note (w/ specific terms)
- All notes contain some interest
- Notes are either:
 - o Interest bearing
 - Have a stated rate of interest, or
 - o Zero-interest bearing (or non-interest bearing)
 - Interest rate not always stated
 - Interest amount is the difference b/w the amount borrowed & the face amount

INTEREST BEARING ST NOTES RECEIVABLE

- Ex: On March 14, 2017, Accounts Receivable of \$1,000 is exchanged for a 6% six-month note

MARCH 14, 2017 (WHEN NOTE IS ISSUED):

NOTES RECEIVABLE	1000
ACCOUNTS RECEIVABLE	1000

SEPTEMBER 14, 2017 (ON COLLECTION OF NOTE):

CASH	1030	$\rightarrow 1000 \times 6\% \times \frac{6}{12}$
NOTES RECEIVABLE	1000	
INTEREST INCOME	30	

NON-INTEREST BEARING ST NOTES RECEIVABLE

- On February 23, 2017, a \$5,000 9-month non-interest bearing note is issued; 8% is the implied interest rate

ON ISSUANCE OF NOTE:

$$8\% \times \frac{9}{12} = 6\% \quad \frac{5000}{(1+0.06)} = 4717$$

NOTES RECEIVABLE	4717
CASH	4717

ON COLLECTION OF NOTE:

CASH	5000	$\rightarrow 4717 \times 8\% \times \frac{9}{12}$
NOTES RECEIVABLE	4717	
INTEREST INCOME	283	

LONG-TERM LOANS RECEIVABLE

- Long-term loans receivable are **recognized at FV**—i.e. the PV of the future CFs
 - o When the stated interest rate is the same as the market interest rate, the note or loan is issued at its face value
 - o When there is a difference b/w interest rates, the note or loan is issued at a premium or a discount (i.e. the PV is greater or less than the face value)

LONG-TERM LOANS RECEIVABLE – INTEREST BEARING NOTES

- **Ex:** Morgan Corp. issues a \$10,000, 10% 3-year note; market interest rate is 12% & annual interest payments are \$1,000 (10% x \$10,000)
- In calculating the **note's PV**, use 12% market rate to discount all future CFs as follows:
 $(\$10,000 \times 0.71178) + (\$1,000 \times 2.40183) = \$9,520$
- The note is issued at a **discount** (as proceeds < face)
- J/E at issuance of note:

Dr. Notes Receivable	9,520	
	Cr. Cash	9,520

- At date of issue, the company has an unamortized discount of \$480 (to be amortized over the 3 years)
- The discount represents interest income to be recognized over the 3 year life of the note
- $\$9,520 \times 12\% = \$1,142$ (first year interest income)
- J/E to record first \$1,000 interest received:

Dr. Cash	1,000	
Dr. Notes Receivable	142	
	Cr. Interest Income	1,142

- Book value of Notes Receivable is now:
 $\$10,000 - (\$480 - \$142) = \$9,662$
- Interest income for 2nd year:
 $9662 \times 12\% = \$1,159$
- J/E to record the 2nd \$1,000 interest received:

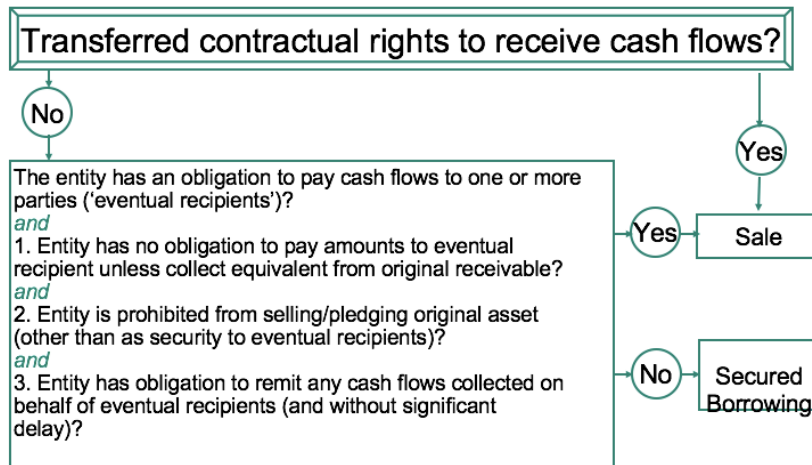
Dr. Cash	1,000	
Dr. Disc. On Notes Receivable	159	
	Cr. Interest Income	1,159

- Under straight-line method (as opposed to the effective interest rate method), initial discount of \$480 is recognized as interest income evenly over 3 years $\$480/3 = \160 per year
- IFRS requires the use of effective interest method of amortization
- ASPE doesn't specify the amortization method

DERECOGNITION OF RECEIVABLE

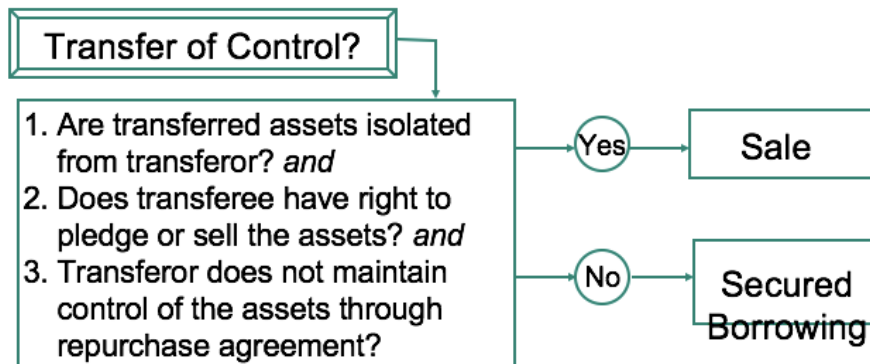
- The holder of accounts or notes receivable may transfer them to another company for cash
- The transfer may be:
 - o A secured borrowing
 - o A sale of receivables
- Holder **retains** ownership of receivables in a secured borrowing transaction; the receivables are used as collateral
- Holder **transfers** ownership of receivables in a sale
- Specific standards are still in state of flux, so focus is on key concepts

BORROWING VS. SALE TREATMENT: IFRS 9 (EFFECTIVE JAN 1, 2015)

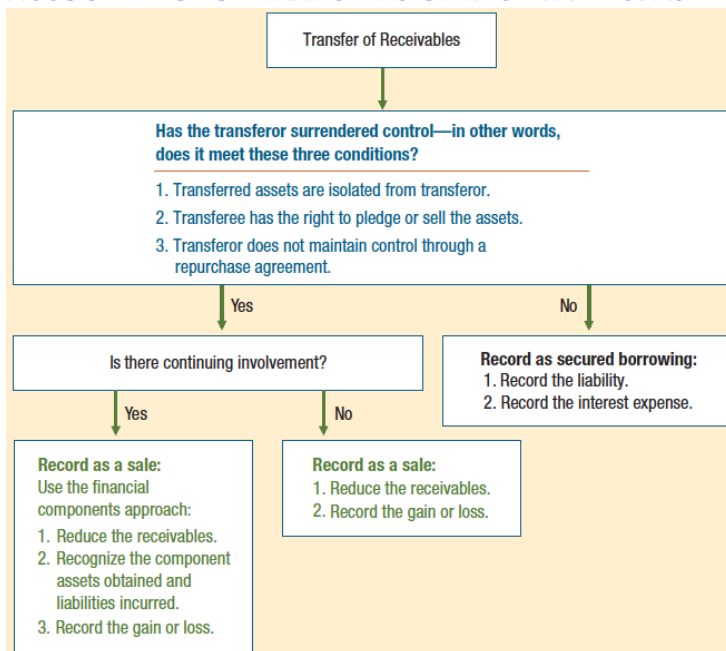


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BORROWING VS. SALE TREATMENT: ASPE



ACCOUNTING FOR TRANSFERS OF RECEIVABLES: ASPE



SECURED BORROWINGS (HIGHLIGHTS)

- Account for receivable (now collateralized) same way as before secured borrowing:
 - o Collect accounts receivable
 - o Record sales returns & sales discounts
 - o **Absorb bad debts expense**
- Account for new liability (e.g. note payable)
 - o Record a **finance charge** (if applicable)
 - o Record interest expense on note payable
 - o Pay the note periodically from collections

SALE OF RECEIVABLES (E.G., FACTORING)

- **Ownership** of receivables transferred to the purchaser (the factor); receivables recorded as an asset in the purchaser's books
- **If sold w/out recourse**, purchaser is fully responsible for collections of the receivables
- Seller records any retained proceeds as "**due from factor**" (a receivable) which covers possible sales discounts & sales returns & allowances
- Seller records **gain/loss on sale** of receivables (normally a loss, representing the finance charge)
- Seller records any **recourse liability** [if receivables are sold **w/ recourse** (i.e., seller's guarantee)]

PRESENTATION OF TRADE ACCOUNTS & NOTES RECEIVABLE

- Segregate types of receivables (i.e. ordinary trade accounts, due from related parties, & other receivables segregated)
- Separate current from non-current receivables
- If > 1 year, report amount & maturity date
- Use allowance account to record impairments (IFRS also requires reconciliation of changes in the allowance account during accounting period)
- Income statement disclosures of interest income, impairment losses, & any reversals of such losses

ANALYSIS

Accounts Receivable Turnover:

$$\frac{\text{Net Sales/Revenue}}{\text{Average Trade Receivables (Net)}}$$

Days Sales Uncollected:

$$\frac{365 \text{ Days}}{\text{A/R Turnover}}$$

COMPARISON

- IFRS generally requires more extensive disclosures
- The 2 sets of standards are very similar
- IFRS allows preferred shares that are close to their maturity date to be qualified as a cash equivalent
- ASPE doesn't require use of the effective interest method, whereas IFRS generally does
- When determining whether an asset should be derecognized, ASPE considers who has control of the asset, whereas IFRS considers whether the risks & rewards of ownership have been transferred.