**CASH AND RECEIVABLES**

**C**ash and receivables require careful oversight to ensure that they are ethically handled. If cash is mismanaged or stolen, it can bring about the downfall of a business. Because accounts receivable and notes receivable require estimates of future losses, they can be easily manipulated to show improvement in reported earnings. Improved earnings can, of course, enhance a company’s stock price, as well as the bonuses of its executives. In this chapter, we address the management of cash and demonstrate the importance of estimates in accounting for receivables.

**Management issues related to cash and receivables**

The management of cash and accounts and notes receivable is critical to maintaining adequate liquidity. These assets are important components of the operating cycle, which also includes inventories and accounts payable. In dealing with cash and receivables, management must address five key issues: managing cash needs, setting credit policies, evaluating the level of accounts receivable, financing receivables, and making ethical estimates of credit losses.

**Cash Management**

On the balance sheet, **cash** usually consists of currency and coins on hand, checks and money orders from customers, and deposits in checking and savings accounts. Cash is the most liquid of all assets and the most readily available to pay debts. It is central to the operating cycle because all operating transactions eventually use or generate cash.

Cash may include a *compensating balance*, an amount that is not entirely free to be spent. A **compensating balance** is a minimum amount that a bank requires a company to keep in its bank account as part of a credit-granting arrangement. Such an arrangement restricts cash; in effect, it increases the interest on the loan and reduces a company’s liquidity.

Most companies experience seasonal cycles of business activity during the year. During some periods, sales are weak; during others, they are strong. There are also periods when expenditures are high, and periods when they are low. For toy companies, college textbook publishers, amusement parks, construction companies, and manufacturers of sports equipment, the cycles are dramatic, but all companies experience them to some degree. Seasonal cycles require careful planning of cash inflows, cash outflows, borrowing, and investing.

**Accounts Receivable and Credit Policies**

Like cash, accounts receivable and notes receivable are major types of short term financial assets (Current Assets). Both kinds of receivables result from extending credit to individual customers or to other companies. Retailers, wholesalers and producers allow customers to make payments a month or more after the date of sale.

As we have indicated, accounts receivable are the short-term financial assets of a wholesaler or retailer that arise from sales on credit. This type of credit is often called trade credit. Terms of trade credit usually range from 5 to 60 days, depending on industry practice and company policy. For some companies that sell to consumers, instalment accounts receivable, which allow the buyer to make a series of time payments, constitute a significant portion of accounts receivable. Department stores, appliance stores, furniture stores, used car dealers, and other retail businesses often offer instalment credit.

Credit sales made to customers in the ordinary course of business. Because loans or credit sales made to employees, officers, or owners of the corporation increase the risk of uncollectibility and conflict of interest, they appear separately on the balance sheet under asset titles like *receivables from employees*.

Normally, individual accounts receivable have debit balances, but sometimes customers overpay their accounts either by mistake or in anticipation of making future purchases. When these accounts show credit balances, the company should show the total credits on its balance sheet as a current liability. The reason for this is that if the customers make no future purchases, the company will have to grant them refunds.

Companies that sell on credit do so to be competitive and to increase sales. In setting credit terms, a company must keep in mind the credit terms of its competitors and the needs of its customers. Obviously, any company that sells on credit wants customers who will pay their bills on time. To increase the likelihood of selling only to customers who will pay on time, most companies develop control procedures and maintain a credit department. The credit department’s responsibilities include examining each person or company that applies for credit and approving or rejecting a credit sale to that customer. Typically, the credit department asks for information about the customer’s financial resources and debts. It may also check personal references and credit bureaus for further information.

Then, based on the information it has gathered, it decides whether to extend credit to the customer. Companies that are too lenient in granting credit can run into difficulties when customers don’t pay.

Evaluating the Level of Accounts Receivable

Two common measures of the effect of a company’s credit policies are **receivable turnover** and **days’ sales uncollected**. The **receivable turnover** shows how many times, on average, a company turned its receivables into cash during an accounting period. It reflects the relative size of a company’s accounts receivable and the success of its credit and collection policies. It may also be affected by external factors, such as seasonal conditions and interest rates. **Days’ sales uncollected** are a related measure that shows, on average, how long it takes to collect accounts receivable. The receivable turnover is computed by dividing net sales by average accounts receivable (net of allowances). Theoretically, the numerator should be net credit sales, but the amount of net credit sales is rarely available in public reports, so investors use total net sales.

**Example 1**

You have collected the following information about a company.

Net Sales for year 2011 Ksh. 19, 176.10

Accounts receivables as at end of 2010 Ksh.2883.90

Accounts receivable as at end of 2011 Ksh. 2795.30

Compute the receivables turnover and the Days’ sales uncollected.

**Solution**

Receivables turnover= Net Sales/ Average accounts receivables

= 19, 176.10/ ((2883.90+2795.30)/2)= 6.8 times

Days’ sales uncollected= 365/receivables turnover= 365/6.8= 53.7 days.

Thus, the company turned its receivables 6.8 times a year, or an average of every 53.7 days.

**Example 2**

The following is an extract balance sheet for a firm for the years 2010 and 2011.

ABC LTD

Extract Statement of financial position,

As at December 31,

2010 2011

Ksh. M Ksh. M

Accounts receivable 10 15

Net sales for the current year (2011) are Ksh. 300 million. Compute

* The receivables turnover.
* Days’ sales uncollected.

**Financing Receivables**

Financial flexibility is important to most companies. Companies that have significant amounts of assets tied up in accounts receivable may be unwilling or unable to wait until they collect cash from their receivables. Many corporations have set up finance companies to help their customers pay for the purchase of their products.

Companies can also raise funds by selling or transferring accounts receivable to another entity, called a **factor**. The sale or transfer of accounts receivable, called **factoring**, can be done with or without recourse. *With recourse* means that the seller of the receivables is liable to the factor (i.e., the purchaser) if a receivable cannot be collected. *Without recourse* means that the factor bears any losses from unpaid accounts. A company’s acceptance of credit cards like Visa, MasterCard, or American Express is an example of factoring without recourse because the issuers of the cards accept the risk of non payment. The factor, of course, charges a fee for its service. The fee for sales with recourse is usually about 2 percent of the accounts receivable. The fee is higher for sales without recourse because the factor’s risk is greater. In accounting terminology, a seller of receivables with recourse is said to be contingently liable. A **contingent liability** is a potential liability that can develop into a real liability if a particular event occurs. In this case, the event would be a customer’s non-payment of a receivable. A contingent liability generally requires disclosure in the notes to the financial statements.

Another way for a company to generate cash from its receivables is through a process called securitization. Under **securitization**, a company groups its receivables in batches and sells them at a discount to companies and investors.

**Ethics and Estimates in Accounting for Receivables**

Companies extend credit to customers because they expect it will increase their sales and earnings, but they know they will always have some credit customers who cannot or will not pay. The accounts of such customers are called **uncollectible accounts**, or *bad debts*, and they are expenses of selling on credit. To match these expenses, or losses, to the revenues they help generate, they should be recognized at the time credit sales are made. Of course, at the time a company makes credit sales, it cannot identify which customers will not pay their bills, nor can it predict the exact amount of money it will lose. Therefore, to adhere to the matching rule, it must estimate losses from uncollectible accounts. The estimate becomes an expense in the fiscal year in which the sales are made. Because the amount of uncollectible accounts can only be estimated and the exact amount will not be known until later, a company’s earnings can be easily manipulated. Earnings can be overstated by underestimating the amount of losses from uncollectible accounts, and they can be understated by overestimating the amount of the losses. Misstatements of earnings can occur simply because of a bad estimate. Uncollectible accounts can be deliberately made to meet analysts’ estimates of earnings, reduce income taxes, or meet benchmarks for bonuses.

Among the many examples of unethical or questionable practices in dealing with uncollectible accounts are the following:

* **WorldCom** (now **MCI**) increased revenues and hid losses by continuing to bill customers for service for years after the customers had quit paying.
* The policy of **Household International**, a large personal finance company, seems to be flexible about when to declare loans delinquent. As a result, the company can vary its estimates of uncollectible accounts from year to year.
* By making large allowances for estimated uncollectible accounts and then gradually reducing them, **Bank One** improved its earnings over several years.
* **HealthSouth** manipulated its income by varying its estimates of the difference between what it charged patients and what it could collect from insurance companies

Exercise

Santorin Company has cash of Ksh.20, 000, net accounts receivable of Ksh.60,000, and net sales of Ksh.500,000. Last year’s net accounts receivable were Ksh.40, 000. Compute the following ratios: receivable turnover and days’ sales uncollected.

**CASH EQUIVALENTS AND CASH CONTROL**

**CASH EQUIVALENTS**

Cash is the asset most readily available to pay debts, but at times a company may have more cash on hand than it needs to pay its debts. Excess cash should not remain idle, especially during periods of high interest rates. Management may decide to invest the excess cash in short-term interest-bearing accounts or certificates of deposit (CDs) at banks and other financial institutions, in government securities (such as GoK Treasury bills), or in other securities. If these investments have a term of 90 days or less when they are purchased, they are called cash equivalents because the funds revert to cash so quickly they are treated as cash on the balance sheet.

Cash and equivalents represent cash and short-term, highly liquid investments with maturities of three months or less at date of purchase. The carrying amounts reflected in the consolidated balance sheet for cash and equivalents approximate fair value

**Fair Value of Cash and Cash Equivalents**

Cash and cash equivalents are financial instruments that are valued at fair value. In most cases, the amount recorded in the records approximates fair value, and most businesses and other entities consider cash equivalents to be very safe investments. Companies often invest these funds in money market funds to earn interest with cash when they don’t need cash for current operations. Money market funds usually invest in very safe securities, such as commercial paper, which is short term debt of other entities. Although money market funds are not guaranteed, investors do not expect losses on these investments.

**Cash Control Methods**

In an earlier chapter, we discussed the concept of internal control and how it applies to cash transactions. Here, we address three additional ways of controlling cash: imprest systems; banking services, including electronic funds transfer; and bank reconciliations.

**Imprest Systems** Most companies need to keep some currency and coins on hand. Currency and coins are needed for cash registers, for paying expenses that are impractical to pay by check, and for situations that require cash advances—for example, when sales representatives need cash for travel expenses. One way to control a cash fund and cash advances is by using an **imprest system**.

A common form of imprest system is a petty cash fund, which is established at a fixed amount. A receipt documents each cash payment made from the fund. The fund is periodically reimbursed, based on the documented expenditures, by the exact amount necessary to restore its original cash balance. The person responsible for the petty cash fund must always be able to account for its contents by showing that total cash and receipts equal the original fixed amount.

**Banking Services** All businesses rely on banks to control cash receipts and cash disbursements. Banks serve as safe depositories for cash, negotiable instruments, and other valuable business documents, such as stocks and bonds. The checking accounts that banks provide improve control by minimizing the amount of currency a company needs to keep on hand and by supplying permanent records of all cash payments. Banks also serve as agents in a variety of transactions, such as the collection and payment of certain kinds of debts and the exchange of foreign currencies.

**Electronic funds transfer (EFT)** is a method of conducting business transactions that does not involve the actual transfer of cash. With EFT, a company electronically transfers cash from its bank to another company’s bank. For the banks, the electronic transfer is simply a bookkeeping entry.

Rarely does the balance of a company’s Cash account exactly equal the cash balance on its bank statement. The bank may not yet have recorded certain transactions that appear in the company’s records, and the company may not yet have recorded certain bank transactions. A bank reconciliation is therefore a necessary step in internal control. A **bank reconciliation** is the process of accounting for the difference between the balance on a company’s bank statement and the balance in its Cash account. This process involves making additions to and subtractions from both balances to arrive at the adjusted cash balance.

**The process of Bank reconciliations**

To illustrate the procedure of bank reconciliation we will use a bank statement and a cash book page both from the month of October 2011 for Mrs. Lyne. The bank statement appears below.

Bank statement

Mrs Lyne

Statement No. 45 Equity Bank

31 October 2011 Account No. 0009870098

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Date  Oct. 2011 | Details | Payments (DR)Ksh. | Receipts (CR) Ksh. | Balance (Ksh.) |
| 1 | Opening balance |  |  | 589 |
| 4 | Credit Transfer Bellwood LTD |  | 240 | 829 |
| 6 | Cheque 101450 | 684 |  | 145 |
| 12 | Direct Debit S. Electricity | 86 |  | 59 |
| 15 | Cheque deposited |  | 298 | 357 |
| 19 | Cheque Deposited |  | 76 | 433 |
| 21 | Interest received |  | 4 | 437 |
| 24 | Standing order to 017643 | 350 |  | 87 |
| 25 | Direct debit Eastern Insurance | 92 |  | (5) OD |
| 27 | Dishonored cheque 19 oct | 76 |  | (81) OD |
| 29 | Cheque deposited |  | 223 | 142 |
| 30 | Cheque 101451 | 115 |  | 27 |
| 31 | Closing balance |  |  | 27 |

The cash book for the same period appears as below:

DR Cash book (Bank only) CR

|  |  |
| --- | --- |
| 2011 | 2011 |
| October 1 Balance b/d 589 | October 4 B. Welsh 684 |
| October 12 F. Brown 298 | October 26 R. Lewis 115 |
| October 15 N. Renshaw 76 | October 27 R. Wakeling 99 |
| October 24 J. Denton 223 | October 29 D. Doyle 204 |
| October 28 L. Webster 430 | October 31 Balance c/d 514 |
| 1616 | 1616 |
| November 1 Balance b/d 514 |  |

As you can see, though the opening balances for the period agree, the closing balances disagree. In order to verify whether or not this disagreement is caused by error we can begin the process of bank reconciliation.

The following is not the only method of completing the bank reconciliation but it is the one that gives a clear procedure to follow. To complete the bank reconciliation, the following steps should be taken:

**1** We need to identify the items that do not appear in the cash book but that are on the bank statement, or that appear in the cash book and are not in the bank statement, as these could be the reason for the discrepancy.

**2** The cash book will need to be brought up to date by entering items found only on the bank statement and not in the cash book.

**3** Draw up a reconciliation statement using the updated cash book balance and items appearing in the cash book that were not on the bank statement.

**Identifying items appearing in the bank statement but that are not in the cash book**

These items are appear in the bank statement but are not in the cash book:

***Credit transfer Bellwood Ltd***

***Direct Debit Southeast Electricity***

***Interest received***

***Standing order to 017643***

***Direct Debit Eastern Insurance***

***Dishonoured cheque 19 Oct***

***Identified them?***

***These items appear in the cash book but are not in the bank statement.***

***L. Webster***

***R. Wakelling***

***D. Doyle***

***Update the cash book***

Increasingly many transactions will appear on a business’s bank statement without the business owner(s) taking any direct action. This is because these transactions are largely automated. Common types of transactions which fall into this category are direct debits, standing orders, credit transfers, interest payments and bank charges.

**Direct debits**

These occur when the business gives permission for a third party to withdraw money from the bank account. Usually this will be to settle a bill. Most utility providers (e.g. gas and electricity suppliers) encourage payment of bills to be made through a direct debit arrangement. They are often paid at the same point each month but the amount paid will vary.

**Standing orders**

A business can arrange for a regular payment of a fixed amount to be made out of its

account. This could be to another business or to a person. Standing orders are similar to direct debits except that the arrangement is made by the business itself and not the recipient of the money.

**Credit transfers**

These refer to money paid directly into our bank account. Whereas direct debits and standing orders usually refer to payments, these refer to receipts.

**Interest/bank charges**

Banks themselves will make entries into our bank account automatically. Interest – both paid and received – will usually appear on a bank statement. Charges made by the banks, e.g. for the use of an overdraft, will also appear.

**Dishonoured cheques**

Although not an automated transaction it is possible that this will appear on our bank statement. If we receive and deposit a cheque then once the cheque is cleared (normally within around three working days) the money is credited (from the bank’s viewpoint) to our account. If the payee of the cheque does not have sufficient funds in their account to make the payment, then the cheque may be dishonoured and the money that was added to the account balance would be cancelled. The business would not know about this immediately but a bank would normally write to a customer to inform them of this (and may also charge them for this).

Cash Book

|  |  |
| --- | --- |
| 2011 | 2011 |
| October 1 Balance b/d 589 | October 4 B. Welsh 684 |
| October 12 F. Brown 298 | October 26 R. Lewis 115 |
| October 15 N. Renshaw 76 | October 27 R. Wakeling 99 |
| October 24 J. Denton 223 | October 29 D. Doyle 204 |
| October 28 L. Webster 430 | October 31 Southeast Electricity 86 |
| October 31 Credit Transfer- Bellwood LTD 240 | October 31 Standing order 350 |
| October 31 Interest 4 | October 31 Eastern Insurance 92 |
|  | October 31 Dishonoured Check 76 |
|  | October 31 Balance c/d 154 |
|  |  |
| 1860 | 1860 |
| November 1 Balance b/d 154 |  |

**Producing the bank reconciliation statement**

There are likely to be entries in the cashbook which do not appear on the bank statement. This is likely to arise out of the following situation. When a business makes or receives payment by cheque then although this can be written immediately into the cash book it will take time before it appears in the bank account. This is largely because of the time taken by the bank to **‘clear’** each cheque. Normally clearing takes around three working days to complete. Therefore any cheques deposited in a bank near the end of a calendar month may well not appear on the bank statement until early in the following month.

There are two types of cheques we will deal with:

* **Unpresented cheques** are those that have been paid out by the business and entered in the cash book but for which the bank has not yet paid out the money.
* **Lodgements not yet credited** are those cheques which we have received and entered in the cash book but for which the bank has not yet added the amount concerned to the balance as per the bank statement. The bank reconciliation statement will appear as follows:

**J Lyne**

**Bank reconciliation statement as at 31 October 2011**

Balance as per updated cash book 154

**Add unpresented cheques:**

R Wakeling 99

D Doyle 204 303

457

**Less Lodgements not yet credited:**

L Webster 430

Balance as per bank statement 27