CHAPTER 6
The Current Asset Classification, Cash, and Accounts Receivable

SYNOPSIS
In this chapter, the author discusses the uses and limitations of the current asset classification, the measurement and recording of cash and accounts receivables, and the major concerns of financial statement users in accounting for these items. The specific topics covered include the nature of cash, cash controls, cash discounts, and bad debts using the allowance method. The international perspective segment discusses accounting for receivables and payables expressed in foreign currencies, and hedging.

The ethics vignette presents the case of a regional bank with admittedly overstated bad debt expense in good periods and understated bad debt expense in poor periods. In this manner, the bank can achieve consistent increases in reported net income across time. The ethical conduct of both the bank executives and the outside auditors is considered.

The Internet research exercise directs the student to access and analyze the activity in the allowance for credit losses account for a major bank, JPMorgan Chase.

The following key points are emphasized in Chapter 6:

1. Current assets, working capital, current ratio, and quick ratio, and how these measures can be used to assess the solvency position of a company.

2. "Window dressing" and the reporting of current assets, working capital, and the current ratio.

3. Techniques used to account for and control cash.

4. Accounts receivable and how they are valued on the balance sheet.

5. The allowance method for uncollectible receivables.

6. Major concerns of financial statement users in the area of receivables reporting.

TEXT/LECTURE OUTLINE
The current asset classification, cash, and accounts receivable.

I. Current assets.

   A. A current asset is any asset that is intended to be converted into cash within one year or the company's operating cycle, whichever is longer. An operating cycle is the time that it takes a company to begin with cash, convert the cash to inventory, sell the inventory, and collect the cash from the sale.

   B. The relative size of current assets across industries.
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C. Measures using current assets: working capital, current ratio and quick ratio.

D. The economic consequences of working capital, the current ratio and the quick ratio.

E. Limitations of the current asset classification

F. A movement toward cash flow accounting.

II. Cash

A. Cash is defined as coin, currency, checking accounts, and negotiable instruments such as personal checks, money orders, certified checks, cashiers' checks, and bank drafts.

B. Restrictions on the use of cash.

C. Proper management of cash.

D. Control of cash.

III. Accounts receivable.

A. An account receivable is an amount owed to a company from selling goods or services to customers on account. The agreement between the company and the customer is usually informal.

B. Importance of accounts receivable

C. Net realizable value: The valuation base for accounts receivable

   1. Net realizable value is the net expected future benefit arising from accounts receivable. NRV represents the amount of cash the company expects to realize from accounts receivable.

   2. NRV equals the face value of the receivable less adjustments for the following items:

      a) Cash discounts.

      b) Bad debts.

      c) Sales returns.

D. Cash discounts

   1. A discount offered by a company to provide incentives to its customers to pay their open accounts promptly.

   2. Methods to account for cash discounts.
(A) Gross method.

(i) The sale and related receivable are recorded at the gross amount of the transaction.

(ii) Recognition is given to the discount only if the customer takes the discount. If the customer takes the discount, Cash Discount is debited for the amount of the discount. This account is a contra revenue account to Sales.

(iii) The gross method is the most common method because it is the easiest to use.

E. The allowance method of accounting for bad debts (uncollectibles)

1. Bad debts are amounts sold to customers on account that the company does not expect to convert into cash.

2. Companies would prefer to have no bad debts, but it would be extremely costly to eliminate all bad debts. Hence, from a cost/benefit perspective, some bad debts are inevitable.

3. Bad debts should be recognized in accordance with both the revenue recognition principle (i.e., bad debts provide after-the-fact evidence that cash collection was not reasonably assured) and the matching principle.

4. Allowance method.

(a) Bad debts are estimated and recognized in the period in which the underlying credit sale took place. That is, the allowance method results in an amount being estimated and recognized for both Bad Debt Charge (which is offset against the company’s sales) and Allowance for Doubtful Accounts (which is offset against the balance in accounts receivable in the period the underlying credit sale took place).

(b) The allowance account is a contra asset account that offsets Accounts Receivable.

(c) The balance in the allowance account represents the amount reported in Accounts Receivable that the company does not expect to eventually collect.

(d) The balance in Bad Debt Charge represents the amount reported in that period's sales that the company does not expect to eventually collect.

(e) Percentage-of-credit-sales approach—bad debt charge is estimated as a percentage of the accounting period's credit sales. This approach takes an income statement approach.

(f) Aging approach.
i) A company decomposes its accounts receivable balance into different ages and uses this aging to compute the balance necessary in Allowance for Doubtful Accounts.

ii) Bad Debt Charge represents the change from the unadjusted to the necessarily adjusted balance in the allowance account. This approach takes a balance sheet valuation focus.

iii) Companies will often use the aging approach to verify the accuracy of the balance in the allowance account computed using the percentage-of-credit-sales approach.

(g) Regardless of the approach used, the balances in both Allowance for Doubtful Accounts and Bad Debt Charge are based on estimates.

i) With the percentage-of-credit-sales approach, the ending balance for Bad Debt Charge is estimated directly and the ending balance for Allowance for Doubtful Accounts is estimated indirectly.

ii) With the aging method, the ending balance for Allowance for Doubtful Accounts is estimated directly and the ending balance for Bad Debt Charge is estimated indirectly.

5. Accounting for sales returns.

6. Accounts receivable from a user's perspective.
   a) Discretion in recognizing receivables and related revenues can result in manipulation of the financial statements.
   b) Judgment in estimating bad debts and sales returns can result in manipulation of the financial statements.
   c) Balance sheet valuation of receivables.
   d) Financial institutions and uncollectible loans.

IV. International perspective: receivables, foreign currencies, and hedging.

V. Review problem

VI. Ethics in the real world.

VII. Internet research exercise.

LECTURE TIPS

1. Students are often puzzled by the computational difference in estimating bad debt expense between the percentage-of-sales and the aging approach. The numerical example below uses the same data set as a basis to demonstrate the alternative approaches. The example can be expanded (Case II) to illustrate the effect of a debit balance in the allowance account before
adjustment. The data was constructed so as to produce results that are different but reasonable, reflecting the inherent subjectivity in the estimation process and the appropriateness of alternative approaches. The example emphasizes that the primary difference between the two methods is which balance is being estimated directly and which balance is being estimated indirectly.

### Data

<table>
<thead>
<tr>
<th>Sales</th>
<th>$1,050,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated % of sales uncollectible</td>
<td>1/2 %</td>
</tr>
<tr>
<td>Accounts receivable balance</td>
<td>$ 75,000</td>
</tr>
<tr>
<td>Estimated % of accounts receivable uncollectible based on an aging analysis</td>
<td>71/2 %</td>
</tr>
</tbody>
</table>

### Case I—Allowance for doubtful accounts

- $250 (Cr.)

### Case II—Allowance for doubtful accounts

- $250 (Dr.)

### Demonstration Examples

Using the percentage-of-sales approach and, alternatively, the aging approach, prepare the entry to record bad debt expense and compute the final balance in Allowance for Doubtful Accounts for each case. Treat each case independently and compare the results.

### Check Numbers

<table>
<thead>
<tr>
<th>Bad Debt Expense</th>
<th>Allowance Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case I—Percentage-of-sales approach</td>
<td>$5,250</td>
</tr>
<tr>
<td>Case I—Aging approach</td>
<td>$5,375</td>
</tr>
<tr>
<td>Case II—Percentage-of-sales approach</td>
<td>$5,250</td>
</tr>
<tr>
<td>Case II—Aging approach</td>
<td>$5,875</td>
</tr>
</tbody>
</table>

### ANSWERS TO IN-TEXT DISCUSSION QUESTIONS

244. Tommy Hilfiger, a clothing manufacturer, designs and markets fashion clothing ultimately sold by retailers. It buys raw materials and converts them to finished products and/or outsources production of its merchandise. Finished goods are then sold to retailers on open account. The operating cycle—the time it takes the company to convert cash to inventory, sell the inventory, and collect cash from the sale—would likely be fairly long, but certainly less than a year.

Toyota, an automobile manufacturer, designs and manufactures automobiles. It buys raw materials and converts them to finished products. Finished goods are then sold to dealers on open account. The operating cycle—the time it takes the company to convert cash to inventory, sell the inventory, and collect cash from the sale—would likely be fairly long, but probably less than a year.

Young & Rubicam, an advertising agency, does not manufacture or sell goods, but rather provides services to its clients. The operating cycle consists of paying salaries to
employees who render the services followed by billing and cash collections. The time it takes the company to convert the services rendered by its employees into cash is probably a month or two.

Lycos, an internet portal, does not manufacture or sell goods, but rather provides services to its customers. The operating cycle here is probably a monthly cycle where customers pay for monthly service.

RadioShack’s primary revenue producing asset is inventory, compared to Simms Property Group which generates revenue primarily from its mall properties. Accordingly, the major asset category on RadioShack’s balance sheet is inventory, a current asset, while Simms’ major asset is property, plant and equipment, a non-current asset category.

Recognizing revenue before the sale was complete would create an overstatement of assets, probably in accounts receivable. The overstatement of accounts receivable enhances the appearance of working capital, thus it fits the description of “window dressing.”

Current and quick ratios are two simple measures of liquidity, neither of which reflects The Wendy’s/Arby’s Group’s true liquidity position. Wendy’s/Arby’s has relatively little in the way of current assets because of the nature of its operations. Wendy’s/Arby’s buys it, fries it, sells it and collects for it all very quickly. Relatively few receivables are from franchisees, and virtually none from their retail customers. Inventories are low and turn over quickly. Wendy’s/Arby’s has a short operating cycle. Current and quick ratios are static measures. Wendy’s/Arby’s liquidity is better assessed with a dynamic measure, such as cash flow from operations (CFFO) compared to current liabilities. On that basis, Wendy’s/Arby’s enjoys a strong ratio of CFFO to current liabilities of about 1 to 1 for recent years.

The restricted cash would not be included with the other current assets in the calculation of working capital because it is not available to pay current liabilities.

Cash management requires managers to maintain enough cash to ensure that the business remains liquid and is able to meet payment obligations, and to invest cash in excess of those needs in assets that produce a higher return. Identifying and estimating cash inflows and cash needs, and determining the amount and where to invest excess cash, are important concerns to company managers.

Company managers desire to keep cash balances at a minimum, and therefore the absolute amount of cash at any one point in time is minimal compared to other assets. Yet, cash transactions are very voluminous and are central to every accounting system. Most liabilities, revenues, expenses, and other assets flow through the cash account. The mere number of transactions leads to a higher likelihood of errors. Also, cash is the most liquid of assets and the most susceptible to theft, embezzlement, and misappropriation. Accordingly, record and physical controls of cash are critical to the accountant.

Paying attention to the relationship between sales and accounts receivable might alert an analyst to a problem. Accounts receivable turnover is a ratio based on this
relationship. An unexplained increase or decrease in receivables turnover may be an indication of an accounting problem.

253. Large companies generally have more economic power than smaller companies and are better able to control the terms of contracts with both their vendors and their customers than are smaller companies. For this reason, smaller companies will usually have more difficulty collecting their receivables and extending the time they have to pay their vendors than the larger companies, especially in an economic downturn.

254. Accounts receivable management and control is likely most important to General Electric. Wal-Mart is a cash and carry business without significant accounts receivable. Walgreens has few receivables. General Electric is a large diversified manufacturer, which also has a finance operation. Receivables are very material to its operations and financial statements.

254. The net realizable value of the $3.41 billion in accounts receivable was only $3.36 billion. The difference is the allowance for doubtful accounts.

257. A company must evaluate the creditworthiness of potential customers before making sales on account to them. This is a costly, and necessarily subjective (and therefore risky) undertaking, especially when it involves a new customer-base in a new market. Managers must balance the profit from the incremental sales gained from credit sales, against a realistic estimate of the bad debt losses that are inevitable if credit is granted.

259. Because Citigroup’s core business is financial services (lending) it may be better at managing the credit card business than Sears was. The “increasingly large reserves” were allowances for doubtful accounts, which are often referred to as “reserves.”

260. The $.6 million charged to expense was the amount of bad debt expense for the year. The $1.6 million of uncollectible receivables written off were written off under Radio Shack’s policy because of doubts as to collectability. Because the write-offs exceeded the expense, the allowance decreased.

262. The inaccurate bad debt estimate for 2002 will result in additional bad debt expense in 2003 or 2004. Users of the financial statements might have detected the problem by comparing the amount in the allowance account to such numbers as sales and accounts receivable across time. Unsatisfactory explanations for unusual deviations may have revealed a problem.

263. There is a trend in American business to outsource functions to others that can perform them more effectively and efficiently, and collection of delinquent receivables is no exception. Companies are willing to sell delinquent receivables for an assured smaller amount now, rather than wait to possibly receive a larger amount later. Mr. Passen is so confident in his new firm’s collection skills, that he believes he can achieve higher returns by actually buying the delinquent receivables and keeping the full amount recovered, than by simply taking a percentage of amounts recovered.

264. The indictment alleges that certain (named) executives kept Computer Associate's books open at the end of fiscal periods. In the week following the end of fiscal periods, while the books were held open, they directed sales managers and salespeople to finalize and backdate license agreements. Revenue from those falsely dated license
agreements was then improperly recognized in the quarter just ended. The executives met routinely and conferred with each other during the week following the end of fiscal periods to determine whether Computer Associate’s had generated sufficient revenue to meet the quarterly projections, and closed Computer Associate’s books only after they determined that Computer Associate’s had generated enough revenue to meet the quarterly projections.

266. Revenue recognition on product sales prior to shipment is not appropriate because the earnings process is not complete until the goods are shipped. Such a practice could result in a receivables write-off if the goods were not in fact subsequently shipped or from a change in accounting to recognize revenue in the proper period.

266. Macy’s decided that they did not want to be in the customer credit business. Rather, they spun that part of the business off, and sold it. Because of the widespread use of credit cards, merchants can sell on credit without carrying the risks involved in financing consumer purchases.

267. Receivables may have increased because sales grew, collections slowed, or because of acquisitions of other companies, or a combination of those factors. An investor’s interpretation of the company’s current ratio and cash flow statement should include an evaluation of the factors underlying the increase to help determine whether the receivables are in fact realizable. A favourable current ratio does not mean much unless the receivables are in fact collectible. Cash flow measures should be used together with the current ratio. A large difference between net income and net cash from operations because of an increase in receivables could be a problem, but not necessarily. If the increase in receivables is commensurate with an increase in sales, it may not be.

268. The increases in accounts receivable of $2,194, $868, and $24 represent earnings that were not collected in the form of cash. Because the operating section of the statement of cash flows starts with net income, the fact that accounts receivable increased needs to be taken into consideration when computing cash provided by operations. That much less cash was provided than would have been the case had accounts receivable not increased.

268. Losses on receivables reduce a bank’s retained earnings, a component of their capital. These impairments of banks’ capital pose a threat to the solvency of individual banks and on a macro-level to our entire banking system and our economy as a whole.