Cash, Receivables and Sales

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Cash, Receivables and Sales

Cash

- Among all of the company´s assets, cash is the one most susceptible to employee fraud.
- The obvious way that employees steal cash is by physically removing it from the company, such as pulling it out of the cash register and walking out the door.
- However there are other, less obvious ways to commit fraud with a company´s cash.
- An employee could falsify documents, causing the company to overpay the employee for certain expenses, to issue an inflated payment, or to make payment to a fictitious company.
- Because of these possibilities, companies develop strict procedures to maintain control of cash.

Cash and Cash Equivalents

- The amount of cash recorded in a company´s balance sheet includes currency, coins, and balances in savings and checking accounts, as well as items acceptable for deposit in these accounts, such as checks received from customers.

- In addition, when a company sells products or services to customers who use *credit cards* or *debit cards*, the cash to be collected from those sales in nearly always included in the total cash balance immediately.

- The reason is that cash from those transactions typically will be deposited electronically into the company´s bank account within a few days.

Cash and Cash Equivalents

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- The balance of cash also includes ***cash equivalents***, which are defined as short-term investments that have a maturity date no longer than three months *from the date of purchase.*

- Common examples of such investments are
  - money market funds,
  - Treasury bills, and
  - certificates of deposit.

- The important point to understand is that all forms of cash and cash equivalents usually are combined and reported as a single asset in the balance sheet of most companies.

Components of the Total Cash Balance

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- Coins and Currency
- Checks Received
- Savings Accounts
- Checking Accounts
- Credit Card Sales
- Debit Card Sales
- Cash Equivalents

Total Cash Balance

Accounts Receivable

- Companies sometimes provide goods or services to customers, not for cash, but on account.

- Formally, ***accounts receivables*** represent the amount of cash owed to a company by its customers from the sale of goods or services on account.

- To understand accounts receivable, we need to start with credit sales, from which account receivable originate.

Credit Sales and Accounts Receivable

- ***Credit sales*** transfer goods or services to a customer today while bearing the risk of collecting payment from that customer in the future.

- Did you ever sell candy as part of a fund-raiser and have the person promise to pay you later? If so, you made a credit sale.

- Credit sales transactions are also known as ***sales on account***.

- Similarly, credit service transactions are also called ***services on account***.

- Companies often combine total sales revenues with total service revenues for reporting total revenues in the income statement.

Credit Sales and Accounts Receivable

- Credit sales typically include an informal credit agreement supported by ***an invoice***.

- ***An invoice*** is a source document that identifies the date of sale, the customer, the specific items sold, the dollar amount of the sale, and the payment terms.

- Payment terms typically require the customer to pay within 30 to 60 days after the sale.

- ***Even though no cash is received at the time of the credit sale, the seller records revenue immediately once goods or services are provided to the customer and future collection from the customer is probable.***

Credit Sales and Accounts Receivable

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- Along with the recognized revenue, at the time of sale the seller also obtains a legal right to receive cash from the buyer.

- ***The legal right to receive cash is valuable and represents an asset of the company.***

- This asset is referred to as ***accounts receivable*** (sometimes called ***trade receivables***).

Benefits and Cost of Extending Credit

- Credit sales are common for many business transactions.

- Often, buyers find it more convenient to make multiple purchases using credit and the make a single payment to the seller at the end of the month.

- In other situations, buyers may not have sufficient cash available at the time of the purchase, or the transaction amount exceeds typical credit card limits.

- In such cases, the seller must be willing to allow a credit sale in order for the transaction to occur.

Benefits and Cost of Extending Credit

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- ***The benefit of extending credit*** is that the seller makes it more conveninet for the buyer to increasing profitability of the company.

- ***The cost of extending credit*** is the delay in collecting cash from customers, and as already discussed, some customers may end up not paying at all.

- These disadvantages reduce the operating efficiency of the company and lead to lower profitability.

Benefits and Cost of Extending Credit

- Realize that one company´s right to *collect* cash corresponds to another company´s (of individual´s) obligation to *pay* cash.

- ***One company´s account receivable is the flip side of another company´s payable.***

Other Types of Receivables

- Other types of receivables are less common than ***accounts receivable***.

- ***Nontrade receivables*** are receivables that originate from sources other than customers.

  - They include tax refund claims, interest receivable, and loans by the company to other entities, including stockholders and employees.

- When receivables are accompanied by formal credit arrangements made with written debt instruments (or notes), we refer to them as ***notes receivable***.

Net Revenues

- When a company sells goods or services to its customers, it often offers a variety of discounts and guarantees that can reduce the amount of cash the company is entitled to receive from those customers.

- We´ll discuss four of these transactions:

    - Trade discounts
    - Sales returns
    - Sales allowances
    - Sales discounts

- After accounting for each of these reductions, a company will calculate its net revenues as total revenues less any amounts for returns, allowances, and discounts.

Trade Discounts

- Trade discounts represents a reduction in the listed price of a good or service.
- Companies typically use trade discounts to provide incentives to larger customers or consumer groups to purchase from the company.
- Trade discounts also can be a way to change prices without publishing a new price list or to disguise real prices from competitors.

Trade Discounts - Example

- As an example, assume F. Y. Eye typically provides laser eye surgery for $3 000.

- To help generate new business, the company offers laser eye surgery in the month of March for only $2 400, which represents a trade discount of 20 % ($3 000 x 20 % = $600 ***trade discount***).

- The amount of $600 is ***trade discount.***

- F. Y. Eye provides this discounted service on account to a customer on March 1.

Trade Discounts - Example

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Notice the following two points:

1. Even though F. Y. Eye normally charges $3 000 for this service, the company can record revenue for only $2 400, because that´s the amount the company is entitled to receive from this customer.

2. The trade discount of $600 is recorded indirectly by simply recording revenue equal to the discounted price. We don´t keep track in a separate account of trade discounts given to customers.

- That´s not the case with sales returns, sales allowances, and sales discounts.

Sales Returns and Sales Allowances

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- Is a customer returns goods previously purchased, we call that a ***sales return***.

- If the customer doesn´t return goods but the seller instead reduces the customer´s balance owed for goods or services provided, we call that a ***sales allowance***.

- We reduce revenue for sales returns using a contra revenue account - Sales Returns.

A Contra Revenue Account

- ***A contra revenue account*** is an account with a balance that is opposite, or contra to that of its related revenue account.

- The reason we use a contra revenue account is to keep a record of the total revenue recognized separate from the reduction due to subsequent sales returns.

- Managers want to keep a record of not only how much their companies are selling, but also how much is being returned.

- A high proportion of returns could be an indication of inventory problems, so it´s important to keep track of both Sales Revenue and Sales Returns.

Sales Allowances

- Sales allowances occur when the seller reduces the customer´s balance owed or provides at least a partial refund because of some deficiency in the company´s good or service.

  - For example, suppose the customer having laser eye surgery on March 1 for $2 400 is not completely satisfied with the outcome of the surgery.

  - F. Y. Eye may allow a $ 400 reduction in the amount owed by the customer.

- In this case, the amount the company is entitled to receive has been reduced to $2 000, and the $2 400 of revenue previously recognized needs to be reduced by the amount of the sales allowance.

- ***We record the sales allowance in a contra revenue account - Sales Allowances.***

Sales Discounts

- Unlike a trade discount, a sales discount represents a reduction, not in the selling price of a good or service, but in the amount to be received from a credit customer if collection occurs within a specified period of time.

- ***A sales discount is intended to provide incentive to the customer for quick payment.***

  - For example if cash is collected from the customer within 10 days, the amount due will be reduced by 2 %. The customer owes $2 000 after the $600 trade discount and the $400 sales allowance.

  - So, if the customer pays within 10 days, she will receive a sales discount of $40 ($2 000 x 2 %).

Estimating Uncollectible Accounts

- Rather than accept only cash payment at the time of sale, should companies extend credit to their customers by selling to them on account?

- ***The upside of extending credit to customers is that it boosts sales by allowing customers the ability to purchase on account and pay cash later.***

- Just think of how many times you wanted t buy food, clothes, electronics, or other items, but you didn´t have cash with you.

- Many customers may not have cash readily available to make a purchase or, for other reasons, simply prefer to buy on credit.

Estimating Uncollectible Accounts

- Even though companies extending credit to their customers do not receive cash at the time of the sale, they have a right to receive cash in the future.

- This right is a valuable resource for the company.

- ***This is why the accounts receivable account is an asset, reported in the company´s balance sheet.***

- If the company expects to receive the cash within one year from the date of the balance sheet, it classifies the receivable as a current asset; otherwise it classifies the receivalbe as a long-term asset.

Estimating Uncollectible Accounts

- ***The downside of extending credit to customers is that not all customers will pay fully on their accounts.***

- Even the most well-meaning customers may find themselves in difficult financial circumstance beyond their control, limiting their ability to repay debt.

- Customers´ accounts that we no longer consider collectible are referred to as ***uncollectible accounts***, of ***bad debts***.

Allowance Method (GAAP)

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- Generally Accepted Accounting Principles (GAAP) require that we account for uncollectible accounts using what´s called ***the allowance method***.

- ***Under the allowance method, a company reports its accounts receivable for the net amount expected to be collected***.

- To do this, the company must estimate the amount of current accounts receivable that will prove uncollectible in the future and report this estimate as a contra asset to its account receivable.
- Accounts receivable we do not expect to collect have no benefit to the company.

- Thus, to avoid overstating the assets of the company, we need to reduce accounts receivable in the balance sheet by an estimate of the amount expected not to be collected.

Allowance Method (GAAP)

- Accounts receivable we do not expect to collect have no benefit to the company.

- Thus, to avoid overstating the assets of the company, we need to reduce accounts receivable in the balance sheet by an estimate of the amount expected not to be collected.

- It´s important to understand the following key point.

- Using the allowance method, we account for events (customer´s bad debts) that have not yet occurred but that are likely to occur.

Allowance Method (GAAP)

- This is different from other transactions you´ve learned about up to this point.
- Those earlier transactions involved recording events that have already occurred, such as purchasing supplies, paying employees, and providing services to customers.
- ***Under the allowance method, companies are required to estimate <u>future</u> uncollectible accounts and report those estimates in the <u>current</u> year.***

Direct White-Off Method (Not GAAP)

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- We´ve just seen how the allowance method for uncollectible account works.
- This is the method required for financial reporting by Generally Accepted Accounting Principles (GAAP).
- However, for tax reporting, companies use an alternative method commonly referred to as the direct white-off method.
- Under the direct white-off method, we write off bad debts only at the time they actually become uncollectible, unlike the allowance method which requires estimation of uncollectible accounts before they even occur.

Direct White-Off Method (Not GAAP)

- ***It is important to emphasize that the direct white-off method is generally not allowed for financial reporting under GAAP.***

- It is only used in financial reporting if uncollectible account are not anticipated or are expected to be very small.

- ***The direct white-off method is primarily used for tax reporting.***

- Companies do not report a tax deduction for bad debts until those bad debts are actually uncollectible.

- ***This is why the direct white-off method of accounting for uncollectible accounts is generally not permitted for financial reporting purposes except in limited circumstances.***

Thank you for your attention.