

Current Assets, Cash, and Accounts Receivable Pratt, Financial Accounting 7e, Chapter 6

Current Assets

- Cash and other assets that will be converted into cash or consumed with one year (or the company's operating cycle, whichever is longer)
- Operating cycle is the Cash->Inventory->Accounts Receivable->Cycle
- Common current assets
 - Cash and Cash Equivalents
 - Short-Term Investments
 - Accounts and Notes Receivable
 - Inventories
 - Prepaid Expenses

Assessing Short Term Solvency

- Working Capital

Working Capital = Current Assets – Current Liabilities

- Current Ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

- Quick Ratio

$$\text{Quick Ratio} = \frac{\text{Cash + Marketable Securities} + \text{Accounts Receivable, Net}}{\text{Current Liabilities}}$$

Cash

- Includes
 - Coins and currency
 - Checking account balances
 - Money Orders
 - Checks
 - Bank Drafts
- Commonly appears as *Cash and Cash Equivalents*
- Cash equivalents are assets that are readily convertible into cash, such as money market holdings, short-term government bonds or Treasury bills, and commercial paper which typically mature in 3 months or less
- Restricted Cash should be identified as such and if necessary reclassified
- Cash management
- Cash controls

Accounts Receivable

- Accounts Receivable arise when a company sells a product or provides a service with the customer agreeing to pay later
- Typical terms are 30 to 60 days

Basic Entries

Example – Smith Company sells on October 1, 2009 for \$10,000 a small machine to Jones Company on account. Jones agrees to pay in 30 days.

Date	Account Titles	Debit	Credit
10/1	Accounts Receivable	10,000	
	Sales		10,000
10/31	Cash	10,000	
	Accounts Receivable		10,000

Cash Discounts

- Some companies offer an incentive called a cash discount to encourage credit customers to pay promptly
- A common cash discounts is 2/10, n/30
- 2/10, n/30 allows the customer to take a 2% discount if they pay in the first ten days, otherwise the will owe the full balance in 30 days

Example – Same as above, except Smith offer Jones terms 2/10, n/30

Date	Account Titles	Debit	Credit
10/1	Accounts Receivable	10,000	
	Sales		10,000
If Jones pays within 10 days			
10/11	Cash	9,800	
	Cash Discount	200	
	Accounts Receivable		10,000
Otherwise			
10/31	Cash	10,000	
	Accounts Receivable		10,000

- Cash Discount is a contra-revenue account

Bad Debts

Issue – If you sell on credit not everyone will pay

Problem – this can result in potentially overstating assets and a mismatching of revenues and expense

Solution – Establish an allowance account

Date	Account Titles	Debit	Credit
At the end of each accounting period			
	Bad Debt Expense		
	Allowance for Doubtful Accounts		
As needed, to write off uncollectible accounts			
	Allowance for Doubtful Accounts		
	Accounts Receivable		

After the allowance is reported the accounts receivable are reported as follows:

Accounts Receivable
Less: Allowance for Doubtful Accounts
Accounts Receivable, Net

In most cases only the net amount is shown.

Based on the entries above answer each of the following:

Effect On	Total Assets	Net Income
Allowance Entry		
Write-Off Entry		

New Problem – how much?

Solution for new problem – estimate using percentage of credit sales method

Example: Historically Delgado Corp. has had 2% of its credit sales provide to be uncollectible. During 2009, the company had \$40,000,000 in credit sales.

$$\text{BDE} = \$40,000,000 \times .02 = \$800,000$$

Date	Account Titles	Debit	Credit
	Bad Debt Expense	800,000	
	Allowance for Doubtful Accounts		800,000

Aging - Another angle on the collectability of accounts receivables

As of 12/31/08 Flores Company had the following balances in accounts receivable.

Due Date	Current	Past Due			Total
		1-30	31-60	Over 60	
1/15/09	24,000				24,000
1/5/09	18,000				18,000
12/15/08		18,000			18,000
11/15/08			16,000		16,000
10/15/08				14,000	14,000
8/15/08				10,000	10,000
Totals	42,000	18,000	16,000	24,000	100,000

New, New Problem #1 - Management Judgment

New, New Problem #2 - Recovery's off accounts previously written off

Date	Account Titles	Debit	Credit
	Accounts Receivable		
	Allowance for Doubtful Accounts		
	Cash		
	Accounts Receivable		

Balance Sheet Valuation of Accounts Receivable - Accounts Receivable should be reported at their net realizable value. This includes estimated allowances for bad debts expense (and estimated sales returns and cash discounts, if material).

Accounts Receivables settled in foreign currencies must be revalued at the end of the accounting period and expose a company to foreign currency risk.

Example: Brueger Corp., a U.S. company sells on December 15, 2009 materials to Ruiz Corporation and agrees to accept 1,000,000 Mexican Pesos (MXN) in 30 days.

Date	Account Titles	Debit	Credit
12/15/09	Accounts Receivable	92,300	
	Sales		92,300
1,000,000 MXN X .09230 USD/MXN			
12/31/09	Exchange Rate Loss	750	
	Accounts Receivable		750
1,000,000 MXN X .09155 USD/MXN			
1/16/10	Cash	91,230	
	Exchange Rate Loss	320	
	Accounts Receivable		91,550
1,000,000 MXN X .09123 USD/MXN			

Companies that sell on credit to customers in other countries can engage in both natural and synthetic hedging strategies to manage foreign exchange risk.