Accounting Fundamentals Lesson 5

5.0 Receivables & Investments

Short-term investments (also known as marketable securities) are easily convertible to cash that a company plans to hold for a year or less.

These are the next-most-liquid assets after cash.

Short-term investments are divided into three categories:

1. Trading securities
2. Available-for-sale securities
3. Held-to-maturity securities.

The purpose of owning a trading security is to hold it for a short time and then sell it for more than its cost. These securities can be in the form of stock or debt of another company.

Trading securities are reported on the balance sheet at their current value.

Unrealized gains and losses are created when the market value increases or decreases from the original purchase amount.

- Short-term investments are current assets that appear on the balance sheet.

- Interest revenue and dividend revenue derived from these investments are shown on the income statement, along with any gains and losses.

Realized gains and losses are created when the investor sells an investment.

When a company provides a good or service to a customer on account, an account receivable is created. Receivables are monetary claims against others.

The accounts receivable account in the general ledger serves as a control account that summarizes the total amount that is to be received from all customers.

Companies also keep a subsidiary ledger of accounts receivable detailing the amount owed by each customer individually.

Notes receivable - a written promise to pay a creditor a definite sum at a specific future date.

Lending money also creates notes receivables.

5.1 Shipping Terms, Sales Discounts, Allowances for uncollectible accounts

Recording Sales of Goods on Credit

When a company sells goods on credit, it reports the transaction on both its income statement and its balance sheet.

FOB Shipping Point

If the sale is made with the terms FOB Shipping Point it means the ownership of the goods is transferred to the buyer at the seller's dock.

This means that the buyer is responsible for transporting the goods from shipping dock. Therefore, all shipping costs (as well as any damage that might be incurred during transit) are the responsibility of the buyer.

FOB Destination

If the sale is made with the terms FOB Destination it means the ownership of the goods is transferred at the buyer's dock.

This means the seller is responsible for transporting the goods to the customer's dock, and will factor in the cost of shipping when it sets its price for the goods.

Credit Terms with Discounts

When a seller offers credit terms of net 30 days, the net amount for the sales transaction is due 30 days after the sales invoice date.

To illustrate the meaning of net, assume that Gem Merchandise Co. sells $1,000 of goods to a customer. Upon receiving the goods the customer finds that $100 of the goods are not acceptable. The customer contacts Gem and is instructed to return the unacceptable goods. This means that Gem's net sale ends up being $900; the customer's net purchase will also be $900 ($1,000 minus the $100 returned). It also means that Gem's net receivable from this customer will be $900.

Companies who sell on credit often find that they don't receive payments from customers on time.

In fact, one study found that if the credit term is net 30 days, the money, on average, arrived 45 days after the invoice date.

In order to speed up these payments, some companies give credit terms that offer a discount to those customers who pay within a shorter period of time.

The discount is referred to as a sales discount, cash discount, or an early payment discount, and the shorter period of time is known as the discount period.

Example:

The term 2/10, net 30 allows a customer to deduct 2% of the net amount owed if the customer pays within 10 days of the invoice date. If a customer does not pay within the discount period of 10 days, the net purchase amount (without the discount) is still due 30 days after the invoice date.

Cash	XX	
Sales Discounts	XX	
Accounts Receivables		XX

Companies do not always collect their entire receivables balance, so companies must account for these uncollectible amounts.

The best way to measure bad debts is by the allowance method.

This method records an estimated amount based on the company's collection experience. This estimated amount is recorded as a debit to Uncollectible Account Expense and a credit to Allowance for Uncollectible Accounts.

The Allowance for Uncollectible Accounts is a contra account to Accounts Receivable.

Two Methods for bad debt:

1. Allowance Method – (aging-of-receivables)
2. Direct write-off Method

- The aging-of-receivables method determines what should be the most relevant, faithful representation of accounts receivable as of the balance sheet date.

Under the aging-of-receivables method, each customer's account balance is reviewed based on how long the balance has been outstanding.

The entry to establish the allowance under the allowance method is:

Uncollectible Accounts Expense	XXX	
Allowance for Uncollectible Accounts		XXX

The entry to write-off an account under the allowance method is:

Allowance for Uncollectible Accounts	XXX	
Accounts Receivable		XXX

The direct write-off method is less preferable as the company records the write-off a customer's balance as the point in time that the receivable becomes uncollectible. No allowance is established, and the method violates the matching principle.

The entry to record an uncollectible account under the direct write-off method is:

Uncollectible Accounts Expense	XXX	
Accounts Receivable		XXX

Notes receivable are more formal than accounts receivable.

Interest is generally charged on a note receivable and is calculated by multiplying the principal by the rate and the time.

- Interest = Principal x Rate x Time

- The principal = the amount borrowed by the debtor
- The rate = percent charged on the note
- The time = the duration of the note's existence

When a note is established, the entry is:

Note Receivable	XXX	
Cash, Sales Revenue, or Accounts Receivable		XXX

The entry to accrue interest revenue at the end of the accounting period is:

Interest Receivable	XXX	
Interest Revenue		XXX

The entry to record the collection of the note and interest on the maturity date is:

Cash	XXX	
Notes Receivable		XXX
Interest Receivable		XXX
Interest Revenue		XXX

The acid-test ratio - measures a company's ability to cover their current liabilities by looking at cash, short-term investments, and net current receivables.

The Acid-test ratio formula is:

$$\text{Acid-test ratio} = \frac{\text{Cash + Short-term investments + Net current receivables}}{\text{Total Current Liabilities}}$$

Days' sales in receivables - tells a company how long it takes to collect its average level of receivables.

The formula is:

$$\text{Days' sales in receivables} = \frac{\text{Average net accounts receivable}}{\text{One day's sales}}$$