

## **CHAPTER 5**

### **ACCOUNTING FOR AND PRESENTATION OF CURRENT ASSETS**

#### **1. Cash and Cash Equivalents**

- Cash includes money on hand in change funds, petty cash, undeposited receipts, and checking and savings accounts
- Cash equivalents are short-term investments easily convertible to cash

#### Bank Reconciliation

- Used to determine that the amount of cash shown in the general ledger is the same as the cash reported by the bank

#### **2. Short-Term Marketable Securities**

- Part of a firm's cash management strategy
- Prudent use of short-term marketable securities as investments can improve ROI
- Examples: U.S. treasury securities, commercial paper, and bank certificates of deposit

#### Reporting of Short-Term Marketable Securities

- Short-term marketable debt securities that are classified as held-to-maturity are reported at cost
- Debt and equity securities that are classified as trading or available-for-sale securities are reported at market value
- Interest on these securities is accrued as it is earned

### **3. Accounts Receivable**

- Are reported on the Balance Sheet at net realizable value – the amount expected to be received from customers
- The amount initially recorded may be different from net realizable due to:
  - Bad debts
  - Cash discounts

#### Bad Debts

- Bad debts are inevitable when sales are made on credit
- Credit managers are able to estimate the amount of bad debts fairly accurately
- Two methods are used to estimate bad debts:

#### Percentage of Credit Sales

- An estimated percentage of credit sales losses is multiplied by the total credit sales
- An entry is made in the firm's records increasing bad debt expense and increasing a valuation adjustment account

#### Aging of Accounts Receivable

- Involves a detailed analysis of age of accounts receivable
- The longer an account is past due, the less likely the firm is to collect the amount owed
- An entry is made in the firm's records increasing bad debt expense and increasing a valuation adjustment account

## Entries Related to Bad Debts

- Recording the estimated amount:

Bad Debt Expense	XX
Allowance for Bad Debts	XX

- Writing off an uncollectible account:

Allowance for Bad Debts	XX
Accounts Receivable	XX

## Cash Discounts

- Are used to encourage prompt payment
- Credit terms often abbreviated as 2/10, n30, meaning a 2 percent discount may be taken if the account is paid within 10 days, and the net amount is due in 30 days
- The estimation of cash discounts is similar to the estimation of bad debts

## **4. Notes Receivable**

- A firm may convert an account receivable into a note receivable if a customer has developed difficulties paying the amount due
- A note receivable is a formal document that includes maturity date, collateral, and penalties
- Notes receivable are also used when lending funds to another entity
- If interest is to be paid on a note receivable at the maturity of the note, the holder accrues interest on a monthly basis
- This shows that interest income has been earned

## **5. Inventories**

- For merchandising and manufacturing firms, the sale of inventory is the major, ongoing source of revenue
- Accounting for inventory is basically the same for all firms
- As inventory is sold, it is moved from an asset to an expense – Cost of Goods Sold
- Amount of cost of goods sold depends on the cost flow assumption used by the firm

### **Inventory Cost Flow Assumptions**

- Four principal alternative cost flow assumptions:
  - Specific Identification
  - Weighted Average
  - First-in, First-out (FIFO)
  - Last-in, First-out (LIFO)
- Only cost flow assumptions, not physical flow assumptions

### **Specific Identification**

- Links cost with the physical flow of goods
- When an item is sold, the cost of that specific item is moved to cost of goods sold
- Not practical for firms with a large number of inventory items

### Weighted-Average

- Applied to individual items of inventory
- Is not a simple average of the costs of the inventory items

### First-In, First-Out (FIFO)

- The first costs in to inventory are the first costs out to cost of goods sold
- The oldest costs are transferred to cost of goods sold
- The balance sheet reports the most current costs of inventory

### Last-In, First-Out (LIFO)

- The most recent costs of inventory are transferred to the income statement - cost of goods sold – when items are sold
- The oldest costs are reported on the balance sheet

### Impact of Changing Costs

- In times of rising costs, LIFO results in lower ending inventory amounts and higher cost of goods sold than FIFO
- When inventory purchase costs are decreasing, FIFO results in lower ending inventory amounts and higher cost of goods sold than LIFO

### Selecting an Inventory Cost-Flow Assumption

- When rates of inflation are low, most financial managers choose FIFO

- In periods of high inflation, managers choose LIFO to avoid high taxes
- However, consistency requires the use of a single cost-flow assumption
- If a change in methods is made, the effect of the change on both the balance sheet and the income statement must be disclosed

### Inventory Accounting System Alternatives

- Accounting for inventory is very complex
- There are two principal inventory accounting systems:
  - Perpetual inventory systems
  - Periodic inventory systems

### Perpetual Inventory Accounting Systems

- A record is made of every purchase and sale
- A continuous record of the quantity and cost of each inventory item is maintained
- Computers and bar codes scanning have aided in the development and use of this system

### Periodic Inventory Accounting Systems

- A count of the inventory on hand is made periodically
- The cost of the inventory on hand, based on the cost-flow assumption being used, is reported on the balance sheet

- The remainder of the beginning inventory and the purchases are reported on the income statement as cost of goods sold

### Inventory Errors

- Errors in the amount of ending inventory have a direct dollar-for-dollar effect on cost of goods sold and net income
- If ending inventory is understated, cost of goods sold will be overstated, and net income will be understated
- The effect in the subsequent period will be reversed

### Balance Sheet Valuation at the Lower of Cost or Market

- This reporting is an application of conservatism
- Market is generally the replacement value
- If market is lower than cost, then a loss is recognized
- The determination may be done on an individual item basis or on the inventory as a whole

### Prepaid Expenses and Other Current Assets

- Prepaid expenses are expenses that have been paid in the current fiscal period but will not be subtracted from revenue until a subsequent fiscal period
- Often referred to as a deferral or deferred charge
- Examples are prepaid insurance, prepaid rent, and office supplies

## **6. Deferred Tax Assets**

- Arise from differences in the fiscal year in which revenues and expenses are recognized for financial accounting purposes and when they are recognized for income tax determination
- Can have deferred tax assets (expenses recognized for financial purposes before they are recognized for tax purposes) and/or deferred tax liabilities (just the opposite)