Lecture 5 Bank Reconciliation and Receivables

The use of a **bank** contributes significantly to good internal control over cash by:

- Minimising the amount of cash that must be kept on hand.
- Generally, internal control over cash payments is more effective when payments are made by using a bank account rather than cash on hand
- Providing a double record of all bank transactions:
  - one by the business
  - one by the bank.
- Helping a company safeguard its cash by using a bank as a depository and clearinghouse for cheques received and written.

Reconciling the bank account involves comparing the bank's records and the firm's bank ledger account. Lack of agreement between firm's books and bank statement can result for two main reasons:

- Timing differences:
  - occurs when the parties record the same transaction in different periods:
  - Unpresented Cheque – lag between when the cheque is written and dated and the date it is paid by the bank.
  - Outstanding deposits – lag between when receipts are recorded by the business and when recorded by the bank.
- Errors
  - **Errors** by either party in recording transactions

Revenue: the **gross inflow** of economic benefit during the period arising in the course of the ordinary activities of an entity when those inflows result in **increases in equity**, other than increases relating to the contributions from equity participations.

Recognition of revenue:

- Revenue is recognized when it is **probable** that **future economic benefits** will flow to the entity and these benefits can be **measured reliably.**

Revenue from the sale of goods shall be recognized when <u>all</u> the following conditions have been satisfied:

1. The entity has **transferred** to the buyer the significant **risks and rewards of ownership** of the goods;
2. The entity retains neither continuing managerial involvement to the degree associated with ownership nor effective control over the goods sold;
3. The amount of revenue can be **measured reliably;**
4. It is **probable** that the **economic benefits** associated with the transaction will flow to the entity; and
5. The cost incurred or to be incurred in respect of the transaction can be measured reliably.

***Case 1**: Goods shipped subject to conditions*

(a) Installation and inspection

Revenue is normally recognized when the buyer accepts delivery, and installation and inspection are complete. However revenue is recognized immediately upon the buyer's acceptance of delivery when:

- The installation process is simple in nature, for example the installation of a factory tested television receiver which only requires unpacking and connection of power and antennae; or
- The inspection is performed only for purposes of final determination of contract prices, for example, shipments of iron ore, sugar or soya beans

***Case 2**: On approval when the buyer has negotiated a limited right of return.*

If there is uncertainty about the possibility of return, revenue is recognized when:

- the shipment has formally been accepted by the buyer **or**
- the goods have been delivered **and** the time period for rejection has elapsed.

***Case 3**: Cash on delivery sale.*

Revenue is recognized when delivery is made and cash is received by the seller or its agent.

***Case 4**: Orders when payment (or partial payment) is received in advance of delivery for goods (or services) not presently held in inventory, for example, the goods are still to be manufactured (or performed) or will be delivered directly to the customers from a third party. (e.g. Gym equipment)*

Revenue is recognized when the goods (or services) are **delivered** to the satisfaction of the buyer.

***Case 5**: Contract is for item and service – example mobile phone contract*

Revenue is recognized in two parts:

- the value of the item (mobile phone); and
- on a periodic basis when service is delivered to the customer.

Rendering of services

Revenue is recognised by reference to the stage of completion of the transaction at reporting date and the outcome can be estimated reliably. i.e.

1. The amount of revenue can be measured reliably
2. It is probable that economic benefits will flow to the entity
3. The **stage of completion (eg. Work in progress or Percentage estimate)** of the transaction can be measured reliably at reporting date; and
4. The costs incurred for the transaction and costs to complete the transaction can be measured reliably

Cash and Receivables:

- For many organizations, cash and receivables are significant assets. Given their significance, it is crucial that cash and receivables are managed and recorded appropriately
- By comparing Cash and Cash Equivalents and Trade Receivables to Total Current Assets, one has an appreciation of the degree of significance that these two assets have on the financial stability and liquidity of the organization.

Types of Receivables:

- **Accounts receivable** are amounts owed by customers on account/invoice.
- **Notes receivable/Promissory Notes** are claims for which formal instruments of credit are issued evidencing the debt (later in the course)
- **Other receivables** include non-trade receivables such as interest receivable, loans, advances and GST receivable (later in the course)
- Accounts receivable are the most significant receivables for most firms. 3 accounting problems associated with accounts receivable are:
  - Recognising accounts receivable
  - Valuing accounts receivable
  - Accelerating cash receipts from receivables (i.e. collecting the cash)

Recognizing notes receivable:

May 1	**Notes Receivable**	**1 000**	
	Accounts Receivable — Brent Ltd		**1 000**
	(To record acceptance of Brent Ltd note)		

Disposing of notes receivable:

Jul 1	**Cash**	**1 000**	
	Notes Receivable		**1 000**
	(To record collection of Brent Ltd note)		

Offering credit terms has both advantages and disadvantages

✓ Increase sales	✗ Risk of non-payment – over valuation
✓ Streamline the sales process (greater convenience)	✗ Not all credit sales will be collected

Lecture 7

A **liability** is a *present obligation* of the entity arising from *past events*, the settlement of which is expected to result in *an outflow* from the entity of resources embodying economic benefits.

A legal obligation is an obligation that derives from:

(a) A contract (through its explicit or implicit terms);
(b) legislation; or
(c) other law eg. Responsibility for others

A basic characteristic of a liability is that the entity has a *present obligation*.

- Obligations may be legally enforceable because of a binding contract; or legislation or other law.
- Obligations also arise, however, from normal business practice, customs and a desire to maintain good business relations or act in an equitable manner.
- For example, a business may decide to rectify faults in its products even when these become apparent after the warranty period has expired.
- Does not have to be legal: the present obligation can be an equitable or a constructive obligation e.g. a warranty to replace an item if faulty.

- Must be a current obligation (for example, future maintenance is not a present liability but an account payable for goods or services is a present liability)

A **constructive obligation** (eg. a warranty for defective goods) is an obligation that derives from an entity's action where:

- By establishing a pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

An **obligating event** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation. For example:

- a customer slips on a wet floor in a supermarket.
- a supplier delivers goods as requested.

A **current liability** is an obligation that can reasonably be expected to be paid within one year or within the operating cycle, whichever is the longer

- Examples include:
  - notes payable/bank bills
  - accounts payable
  - revenue received in advance
  - accrued expenses (liabilities)
- Liabilities that do not meet this definition are classified as **non-current**

Payroll and payroll deductions payable

- Employers deduct amounts from employees' wages and salaries if they are required to be paid to other parties
- These include deductions for:
  - Tax (pay-as-you-go or PAYG)
  - Superannuation
  - Trade union fees
  - Health insurance
- Employers are responsible to remit these withheld funds to the appropriate parties

Mar 7	Salaries and Wages Expense (E)	100 000	
	Pay-as-you-go Withheld Tax Payable (L)		32 036
	Salaries and Wages Payable (L)		67 964
	(To record payroll and withheld taxes for the week ending 7 March)		
Mar 10	Salaries and Wages Payable (L)	67 964	
	Cash (A)		67 964
	(To record payment of 7 March payroll)		
Apr 6	Pay-as-you-go Withheld Tax Payable (L)	32 036	
	Cash (A)		32 036
	(To record payment of withheld taxes for March)		

Revenues received in advance

- Revenues received in advance occur when customers pay ahead of time for goods or services
- There is an obligation to deliver service, ie. a liability
- e.g. Purchase of plane tickets, Magazine subscriptions, Season passes to sporting events
- When is revenue recognized? At receipt of cash or when obligation ceases?
    - **Answer**: When the obligation ceases.

Aug 6	Cash (A)	500 000	
	Ticket Revenue Received in Advance (L)		500 000
	(To record sale of 10 000 season tickets)		

Upon completion of service:

Sep 5	Ticket Revenue Received in Advance (L)	100 000	
	Football Ticket Revenue (R)		100 000
	(To record football ticket revenue earned to date)		

Notes Payable

- Notes payable or Bank Bills record obligations in the form of written agreement (securities)
- Borrower required to pay interest or borrowing costs
- Frequently issued to meet short-term financing needs
- Issued for varying periods of time

Mar 1	Cash (A)	100 000	
	Notes Payable (L)		100 000
	(To record issue of 12%, 4-month note to West State Bank)		
Jun 30	Interest Expense (E)	4 000	
	Interest Payable (L)		4 000
	(To accrue interest for 4 months on West State Bank note)		

Settling liabilities:

Jul 1	Notes Payable (L)	100 000	
	Interest Payable (L)	4 000	
	Cash (A)		104 000
	(To record payment of West State Bank interest-bearing note and accrued interest at maturity)		

Provisions & Other Liabilities:

- **Provisions** can be distinguished from other liabilities such as (a) **trade payables** and (b) **accruals** because there is <u>uncertainty</u> about the timing or <u>amount</u> of the future expenditure required in settlement.
    - Provisions are liabilities for which the **amount** of and **timing** of the **future sacrifice** is still **uncertain**
    - e.g. Provision for: long service leave; warranty; repairs and maintenance
    - Involve significant level of uncertainty

    - Have sometimes been a means of managing earnings
- **Trade payables** are liabilities to pay for goods and services that have been received or supplied and have been invoiced or formally agreed with the supplier
- **Accruals** are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay).
    - Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.
- A provision shall be recognized when:
    - An entity has a **present obligation** (legal or constructive) as a result of a past event;
    - It is **probable (not certain) that an outflow of resources** embodying economic benefits will be required to settle the obligations; and
    - A **reliable estimate** can be made of the amount of the obligation.
- A **warranty** is an obligation of the supplier of goods or services to the purchaser that the product will be functional
    - There is **significant uncertainty** in measuring the future sacrifice because:
    - It is conditional upon the customer making a claim
    - The costs of satisfying the claim depend on the nature of the fault