

## CHAPTER 7

# Financial Assets

*After studying this chapter, you should be able to:*

## Learning Objectives

**LO7-1**

Define financial assets and explain their valuation in the balance sheet.

**LO7-2**

Describe the objectives of cash management and internal controls over cash.

**LO7-3**

Prepare a bank reconciliation and explain its purpose.

**LO7-4**

Describe how short-term investments are reported in the balance sheet and account for transactions involving marketable securities.

**LO7-5**

Describe internal controls over accounts receivable.

**LO7-6**

Account for uncollectible receivables using the allowance and direct write-off methods.

**LO7-7**

Explain, compute, and account for notes receivable and interest revenue.

**LO7-8**

Evaluate the liquidity of a company's accounts receivable.



## APPLE INC.

Apple Inc. is a company that designs, manufactures, and markets mobile communication and media devices, personal computers, and portable digital music players and sells a variety of related software, services, and peripherals. The company has operations worldwide, and its reportable operating segments are the Americas, Europe, Greater China, Japan, and Rest of Asia-Pacific.

You might assume that the company has most of its resources tied up in plant assets, and, in fact, the company's balance sheet recently reported \$22.5 billion in property, plant, and equipment. However, the same balance sheet reported total assets of \$290 billion. Therefore, property and equipment make up only 7.8 percent of Apple's total assets.

Financial assets, including non-trade receivables, of \$236 billion comprise 81 percent of Apple's total assets. Financial assets are a company's most liquid

resources. They include cash, cash equivalents, marketable securities (both short term and long term), accounts receivable, and notes receivable.

Apple is fortunate to have an abundance of liquid resources. In challenging economic times, when the ability to generate or borrow money may be difficult, companies can use their financial assets that are easily and directly convertible into known amounts of cash to continue operations and purchase inventory, pay bills, and honor commitments to employees.

Our coverage of financial assets throughout this chapter includes discussion of the risks associated with holding financial assets. We address topics including commercial paper and other cash equivalents, the volatility of investment portfolios, and the inability of companies to collect outstanding accounts receivable. ■

Financial assets are a company's most liquid (or cashlike) resources. The ability of a company to service its debt, purchase inventory, pay taxes, and cover payroll obligations hinges on the availability of these highly liquid assets. In this chapter, we will examine how companies determine and report the *current values* of financial assets, and how effective companies quickly convert certain financial assets into cash.

## HOW MUCH CASH SHOULD A BUSINESS HAVE?

In response to this question, most businesspeople would say, "As little as necessary." In a well-managed company, daily cash receipts are deposited promptly in the bank. Often, a principal source of these daily receipts is the collection of accounts receivable. If the daily receipts exceed routine cash outlays, the company can meet its obligations while maintaining relatively low balances in its bank accounts.

Cash that will not be needed in the immediate future often is invested in highly liquid short-term securities. These investments are more productive than cash because they earn revenue in the forms of interest and dividends. If the business should need more cash than it has in its bank accounts, it can easily convert some of its investments back into cash.

The term **financial assets** describes not just cash but also those assets easily and directly convertible into known amounts of cash. These assets include cash, short-term investments (also called **marketable securities**), and receivables. We address these three types of financial assets in a single chapter because they are so closely related. All of these assets represent forms of money; financial resources flow quickly among these asset categories.

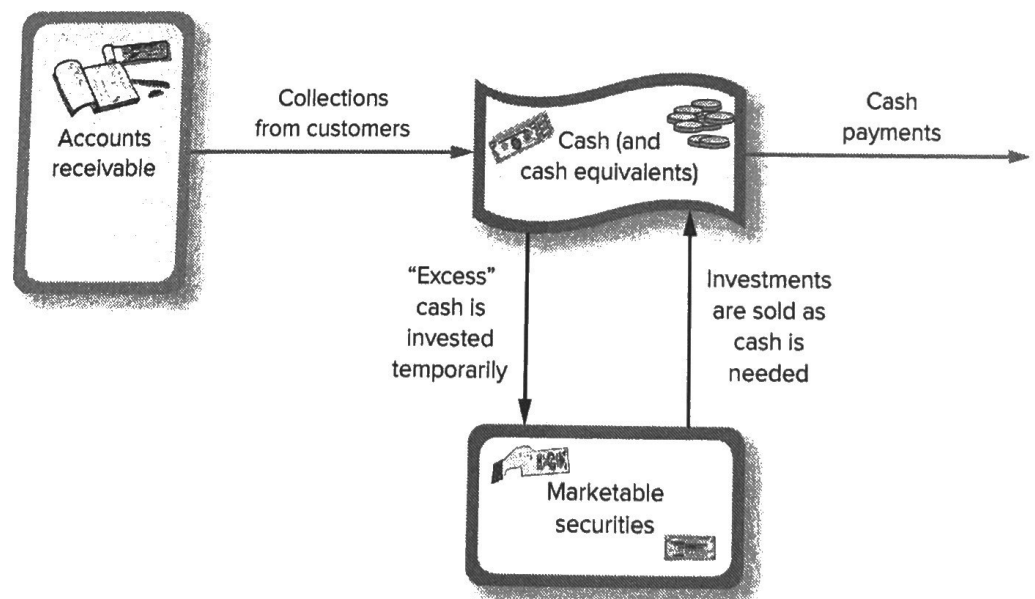
In summary, businesses "store" money in three basic forms: cash, short-term investments, and receivables. The flow of cash among these types of financial assets is illustrated in Exhibit 7-1.

LO7-1

### LEARNING OBJECTIVE

Define financial assets and explain their valuation in the balance sheet.

**EXHIBIT 7-1**  
Money Flows among the  
Financial Assets



## THE VALUATION OF FINANCIAL ASSETS

In the balance sheet, financial assets are shown at their *current values*, meaning the amounts of cash that these assets represent. Interestingly, current value is measured differently for each type of financial asset.

The current value of cash is simply its face amount. But the current value of marketable securities may change daily, based on fluctuations in stock prices, interest rates, and other factors. Therefore, most short-term investments appear in the balance sheet at their current *market values*. (Notice that the valuation of these investments represents an exception to the cost principle.)

Accounts receivable, like cash, have stated face amounts. But large companies usually do not expect to collect every dollar of their accounts receivable. Some customers simply will be unable to make full payment. Therefore, receivables appear in the balance sheet at the estimated *collectible* amount—called **net realizable value**.

The three methods of measuring the current value of financial assets are summarized in Exhibit 7-2.

Type of Financial Asset	Basis for Valuation in the Balance Sheet
Cash (and cash equivalents)	Face amount
Short-term investments (marketable securities)	Fair market value
Receivables	Net realizable value

**EXHIBIT 7-2**

Methods of Measuring the Current Value of Financial Assets

## Cash

Accountants define *cash* as money on deposit in banks and any items that banks will accept for deposit. These items include not only coins and paper money, but also checks, money orders, and travelers' checks. Banks also accept drafts signed by customers using bank credit cards, such as **Visa** and **MasterCard**. Thus sales to customers using bank cards are considered *cash sales*, not credit sales, to the enterprise that makes the sale.

Most companies maintain several bank accounts as well as keep a small amount of cash on hand. Therefore, the Cash account in the general ledger is often a *control account*. A cash subsidiary ledger includes separate accounts corresponding to each bank account and each supply of cash on hand within the organization.

### REPORTING CASH IN THE BALANCE SHEET

Cash is listed first in the balance sheet because it is the most liquid of all assets. For purposes of balance sheet presentation, the balance in the Cash control account is combined with that of the control account for **cash equivalents**.

**Cash Equivalents** Some short-term investments are so liquid that they are termed *cash equivalents*. Examples include money market funds, U.S. Treasury bills, and high-grade commercial paper (very short-term notes payable that are issued by large, creditworthy corporations). These assets are considered so similar to cash that they are combined with the amount of cash in the balance sheet. Therefore, the first asset listed in the balance sheet often is called **Cash and Cash Equivalents**.

To qualify as a cash equivalent, an investment must be very safe, have a very stable market value, and mature within 90 days of the date of acquisition. Investments in even the highest quality stocks and bonds of large corporations are *not* viewed as meeting these criteria. Short-term investments that do not qualify as cash equivalents are listed in the balance sheet as **Marketable Securities**.

**Restricted Cash** Some bank accounts are restricted as to their use, so they are not available to meet the normal operating needs of the company. For example, a bank account may contain cash specifically earmarked for the repayment of a noncurrent liability, such as a bond payable. Restricted cash should be presented in the balance sheet as part of the section entitled "Investments and Restricted Funds."

As a condition for granting a loan, banks often require the borrower to maintain a **compensating balance** (minimum average balance) on deposit in a non-interest-bearing checking account. This agreement does not actually prevent the borrower from using the cash, but it does mean the company must quickly replenish this bank account. Compensating balances are included in the amount of cash listed in the balance sheet, but these balances should be disclosed in the notes accompanying the financial statements.

**Lines of Credit** Many businesses arrange lines of credit with their banks. A **line of credit** means that the bank has agreed in advance to lend the company any amount of money up to a specified limit. The company can borrow this money at any time simply by drawing checks on a special bank account. A liability to the bank arises as soon as a portion of the credit line is used.

The unused portion of a line of credit is neither an asset nor a liability; it represents only the ability to borrow money quickly and easily. Although an unused line of credit does not appear as an asset or a liability in the balance sheet, it increases the company's liquidity. Thus unused lines of credit usually are *disclosed* in notes accompanying the financial statements. For example, PC Connection, recently included the following information in its financial report:

As of December 31, 2014, no borrowings were outstanding against our \$50 million bank line of credit, which is available until February 24, 2017. This line of credit can be increased, at our option, to \$80 million for approved acquisitions or other uses authorized by the bank.

## CASH MANAGEMENT

The term **cash management** refers to planning, controlling, and accounting for cash transactions and cash balances. Because cash moves so readily between bank accounts and other financial assets, cash management really means the management of all financial resources. Efficient management of these resources is essential to the success—even to the survival—of every business organization. The basic objectives of cash management are as follows.

- Provide accurate accounting for cash receipts, cash disbursements, and cash balances.
- Prevent or minimize losses from theft or fraud.
- Anticipate the need for borrowing and assure the availability of adequate amounts of cash for conducting business operations.
- Prevent unnecessarily large amounts of cash from sitting idle in bank accounts that produce no revenue.

## INTERNAL CONTROL OVER CASH

Internal control over cash is sometimes regarded merely as a means of preventing fraud and theft. A good system of internal control, however, will also aid in achieving the other objectives of efficient cash management, including accurate accounting for cash transactions, anticipating the need for borrowing, and the maintenance of adequate but not excessive cash balances.

The major steps in achieving internal control over cash transactions and cash balances include the following.

- Separate the function of handling cash from the maintenance of accounting records. Employees who handle cash should not have access to the accounting records, and accounting personnel should not have access to cash.
- Prepare cash budgets (or forecasts) of planned cash receipts, cash payments, and cash balances, scheduled month-by-month for the coming year.
- Prepare a control listing of cash receipts at the time and place the money is received.
- Require that all cash receipts be deposited daily in the bank.
- Make all payments by check. The only exception should be for small payments to be made in cash from a petty cash fund.

L07-2

### LEARNING OBJECTIVE

Describe the objectives of cash management and internal controls over cash.

Cash

- Require that every expenditure be verified before a check is issued in payment. Separate the function of approving expenditures from the function of signing checks.
- Promptly reconcile bank statements with the accounting records. The person who reconciles the bank statements should not have any opportunities to physically handle cash. (Bank statement reconciliations are discussed later in this chapter.)

**Cash Over and Short** In the handling of daily cash transactions, a few minor errors inevitably will occur. These errors may cause a cash shortage or overage at the end of the day when the cash is counted and compared with the reading on the cash registers.

For example, assume that total cash sales recorded during the day amount to \$4,500. However, the cash receipts in the register drawers total only \$4,485. The following entry would be made to adjust the accounting records for this \$15 shortage in the cash receipts.

Cash Over and Short .....	15
Cash .....	15
To record a shortage in cash receipts for the day	

The account entitled Cash Over and Short is debited for shortages and credited with overages. If the account has a debit balance, it appears in the income statement as a miscellaneous expense; if it has a credit balance, it is shown as a miscellaneous revenue.

## BANK STATEMENTS

Each month the bank provides the depositor with a statement of the depositor's account.<sup>1</sup> As illustrated in Exhibit 7-3, a bank statement shows the account balance at the beginning of the month, the deposits, the checks paid, any other additions and subtractions during the month, and the new balance at the end of the month. (To keep the illustration short, we have shown a limited number of deposits rather than one for each business day in the month.)

## RECONCILING THE BANK STATEMENT

A **bank reconciliation** is a schedule explaining any differences between the balance shown in the bank statement and the balance shown in the depositor's accounting records. The bank and the depositor maintain independent records of the deposits, the checks, and the current balance of the bank account. Each month, the depositor should prepare a bank reconciliation to verify that these independent sets of records are in agreement. This reconciliation may disclose internal control failures, such as unauthorized cash disbursements or failures to deposit cash receipts, as well as errors in either the bank statement or the depositor's accounting records. In addition, the reconciliation identifies certain transactions that must be recorded in the depositor's accounting records and helps to determine the actual amount of cash on deposit.

L07-3

**LEARNING OBJECTIVE**  
Prepare a bank reconciliation and explain its purpose.

**Normal Differences between Bank Records and Accounting Records** The balance shown in a monthly bank statement seldom equals the balance appearing in the depositor's accounting records. Certain transactions recorded by the depositor may not have been recorded by the bank. The most common examples are:

- **Outstanding checks.** Checks issued and recorded by the company but not yet presented to the bank for payment.
- **Deposits in transit.** Cash receipts recorded by the depositor that reached the bank too late to be included in the bank statement for the current month.

<sup>1</sup> Large businesses may receive bank statements on a weekly basis.

**EXHIBIT 7-3**  
**A Bank Statement**

Western National Bank 100 Olympic Boulevard Los Angeles, CA		Customer Account No. 501390 Parkview Company 109 Parkview Road Los Angeles, CA	
<b>Bank Statement for the Month Ended July 31, 2018</b>			
Date			Amount
June 30	Previous statement balance .....		\$ 5,029.30
<b>Deposits and Other Increases (Credits)</b>			
July 1		300.00	
July 2		1,250.00	
July 8		993.60	
July 12		1,023.77	
July 18		1,300.00	
July 22		500.00	CM
July 24		1,083.25	
July 30		711.55	
July 31		24.74	INT
	Total deposits and other increases (credits) .....		7,186.91
<b>Checks Written and Other Decreases (Debits)</b>			
July 2	Ck. 882	1,100.00	
July 3	Ck. 883	415.20	
July 3	Ck. 884	10.00	
July 10	Ck. 885	96.00	
July 10	Ck. 886	400.00	
July 12	Ck. 887	1,376.57	
July 15	Ck. 889	425.00	
July 18	Ck. 892	2,095.75	
July 22	Ck. 893	85.00	
July 22		5.00	DM
July 24	Ck. 894	1,145.27	
July 30		50.25	NSF
July 31		12.00	SC
	Total checks written and other decreases (debits) .....		(7,216.04)
July 31	Balance this statement .....		\$5,000.17
<b>Explanation of Symbols</b>			
CM	Credit Memoranda		
DM	Debit Memoranda		
INT	Interest Earned on Average Balance		
NSF	Not Sufficient Funds		
SC	Service Charge		

In addition, certain transactions appearing in the bank statement may not have been recorded by the depositor. For example:

- **Service charges.** Banks often charge a fee for handling small accounts. The amount of this charge usually depends on both the average balance of the account and the number of checks paid during the month.
- **Charges for depositing NSF checks.** NSF stands for Not Sufficient Funds. When checks from customers are deposited, the bank generally gives the depositor immediate credit. On occasion, one of these checks may prove to be uncollectible, because the customer who wrote the check did not have sufficient funds in his or her account. In such cases, the bank will reduce the depositor's account by the amount of this uncollectible item and return the check to the depositor marked NSF. The depositor should view an NSF check as an account receivable from the customer, not as cash.
- **Credits for interest earned.** Checking accounts may earn interest. At month-end, this interest is credited to the depositor's account and reported in the bank statement.
- **Miscellaneous bank charges and credits.** Banks charge for services—such as printing checks, handling collections of notes receivable, and processing NSF checks. The bank

Cash

deducts these charges from the depositor's account and notifies the depositor by including a debit memorandum in the monthly bank statement. If the bank collects a note receivable on behalf of the depositor, it credits the depositor's account and issues a credit memorandum.<sup>2</sup>

In a bank reconciliation, the balances shown in the bank statement and in the accounting records are both adjusted for any unrecorded transactions. Additional adjustments may be required to correct any errors discovered in the bank statement or in the accounting records.

**Steps in Preparing a Bank Reconciliation** The specific steps in preparing a bank reconciliation are as follows.

1. Compare deposits listed in the bank statement with the deposits shown in the accounting records. Any deposits not yet recorded by the bank are deposits in transit and should be added to the balance shown in the bank statement.
2. Compare checks paid by the bank with the corresponding entries in the accounting records. Any checks issued but not yet paid by the bank should be listed as outstanding checks to be deducted from the balance reported in the bank statement.
3. Add to the balance per the depositor's accounting records any credit memoranda issued by the bank that have not been recorded by the depositor.
4. Deduct from the balance per the depositor's records any debit memoranda issued by the bank that have not been recorded by the depositor.
5. Make appropriate adjustments to correct any errors in either the bank statement or the depositor's accounting records.
6. Determine that the adjusted balance of the bank statement is equal to the adjusted balance in the depositor's records.
7. Prepare journal entries to record any items in the bank reconciliation listed as adjustments to the balance per the depositor's records.

**Illustration of a Bank Reconciliation** The July bank statement sent by the bank to Parkview Company was illustrated in Exhibit 7-3. This statement shows a balance of cash on deposit at July 31 of \$5,000.17. Assume that on July 31, Parkview's ledger shows a bank balance of \$4,262.83. The employee preparing the bank reconciliation has identified the following reconciling items.

1. A deposit of \$410.90 made after banking hours on July 31 does not appear in the bank statement.
2. Four checks issued in July have not yet cleared the bank. These checks are as follows.

Check No.	Date	Amount
881	July 1	\$100.00
888	July 14	10.25
890	July 16	402.50
891	July 17	205.00

3. Two credit memoranda were included in the bank statement.

Date	Amount	Explanation
July 22	\$500.00	Proceeds from collection of a non-interest-bearing note receivable from J. David. The bank's collection department collected this note for Parkview Company.
July 31	24.74	Interest earned on average account balance during July.

<sup>2</sup> Banks view each depositor's account as a *liability*. Debit memoranda are issued for transactions that reduce this liability, such as bank service charges. Credit memoranda are issued to recognize an increase in this liability, as results, for example, from interest earned by the depositor.

4. Three debit memoranda accompanied the bank statement.

Date	Amount	Explanation
July 22	\$ 5.00	Fee charged by bank for handling collection of note receivable.
July 30	50.25	Check from customer J. B. Ball deposited by Parkview Company charged back as NSF.
July 31	12.00	Service charge by bank for the month of July.

5. Check no. 893 was issued to the telephone company in the amount of \$85 but was erroneously recorded in the cash payments journal as \$58. The check, in payment of telephone expense, was paid by the bank and correctly listed at \$85 in the bank statement. In Parkview's ledger, the Cash account is *overstated* by \$27 because of this error ( $\$85 - \$58 = \$27$ ).

The July 31 bank reconciliation for Parkview Company is shown in Exhibit 7-4. (The numbered arrows coincide both with the steps in preparing a bank reconciliation and with the reconciling items just listed.)

**EXHIBIT 7-4**  
The Bank Reconciliation

<b>PARKVIEW COMPANY</b>		<b>BANK RECONCILIATION</b>		<b>JULY 31, 2018</b>	
	Balance per bank statement, July 31, 2018			\$5,000.17	
① →	Add: Deposit of July 31 not recorded by bank			410.90	
				<u>\$5,411.07</u>	
② →	Deduct: Outstanding checks:				
	No. 881	\$100.00			
	No. 888	10.25			
	No. 890	402.50			
	No. 891	205.00		717.75	
	Adjusted cash balance			<u>\$4,693.32</u>	
	Balance per depositor's records, July 31, 2018			\$4,262.83	
③ →	Add: Note receivable collected for us by bank	\$500.00			
	Interest earned during July	24.74		524.74	
				<u>\$4,787.57</u>	
④ →	Deduct: Collection fee	\$ 5.00			
	NSF check of J. B. Ball	50.25			
	Service charge	12.00			
⑤ →	Error on check stub no. 893	27.00		94.25	
	Adjusted cash balance (as above)			<u><u>\$4,693.32</u></u>	

**Updating the Accounting Records** The last step in reconciling a bank statement is to update the depositor's accounting records for any unrecorded cash transactions brought to light. In the bank reconciliation, every adjustment to the balance per depositor's records is a cash receipt or a cash payment that has not been recorded in the depositor's accounts. Therefore, each of these items should be recorded.

In this illustration and in our assignment material, we follow a policy of making one journal entry to record the unrecorded cash receipts and another to record the unrecorded cash reductions. (Acceptable alternatives would be to make separate journal entries for each item or to make one compound entry for all items.) On the basis of our recording policy, the entries to update the accounting records of Parkview Company are as follows.

Short-Term Investments

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Cash .....	524.74
Notes Receivable .....	
Interest Revenue .....	500.00
To record collection of note receivable from J. David collected by bank and interest earned on bank account in July.	24.74
Bank Service Charges .....	
Accounts Receivable (J. B. Ball) .....	17.00
Telephone Expense .....	50.25
Cash .....	27.00
To record bank charges (service charge, \$12; collection fee, \$5); to reclassify NSF check from customer J. B. Ball as an account receivable; and to correct understatement of cash payment for telephone expense.	94.25

A=L-LOE Per bank credit memoranda.

A=L-LOE Per bank debit memoranda.

## Short-Term Investments

Companies with large amounts of liquid resources often hold most of these resources in the form of marketable securities rather than cash.

Marketable securities consist primarily of investments in bonds and in the capital stocks of publicly owned corporations. These marketable securities are traded (bought and sold) daily on organized securities exchanges, such as the New York Stock Exchange, the Tokyo Stock Exchange, and Mexico's *Bolsa*. A basic characteristic of all marketable securities is that they are readily marketable—meaning that they can be purchased or sold quickly and easily at quoted market prices.

Investments in marketable securities earn a return for the investor in the form of interest, dividends, and—if all goes well—an increase in market value. Meanwhile, these investments are almost as liquid as cash itself. They can be sold immediately over the telephone, simply by placing a “sell order” with a brokerage firm such as Merrill Lynch or Morgan Stanley, or on the Internet, by using an online brokerage firm such as E\*TRADE Financial.

Due to their liquidity, investments in marketable securities often are listed immediately after Cash in the balance sheet and are most often classified as available for sale securities.<sup>3</sup> However, if the company plans to hold a marketable security for more than one year, then the security would be classified as a noncurrent asset.

### CASE IN POINT

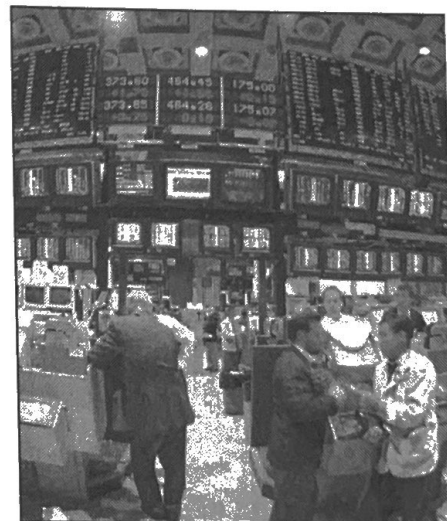
It is common for enterprises to invest a portion of their excess cash in marketable securities in anticipation of earning higher returns than they would by keeping these funds in the form of cash and cash equivalents. The following sample taken from recently issued balance sheets illustrates the willingness of companies to invest millions, even billions, of dollars in short-term marketable securities.

	Amount Invested
3M .....	\$ 626 million
The Coca-Cola Company .....	\$ 3.7 billion
Ford Motor Company .....	\$ 20.9 billion
Pfizer, Inc. ....	\$ 32.8 billion
Microsoft Corporation .....	\$ 90.9 billion

L07-4

#### LEARNING OBJECTIVE

Describe how short-term investments are reported in the balance sheet and account for transactions involving marketable securities.



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<sup>3</sup> Other investment classifications include *trading* securities and *held-to-maturity* securities. These classifications are discussed in more advanced courses.

## Accounting for Marketable Securities

There are four basic events relating to investments in marketable securities: (1) the purchase of investments, (2) the receipt of dividends or interest revenue, (3) the sale of investments, and (4) end-of-period adjustments.

### PURCHASE OF MARKETABLE SECURITIES

Investments in marketable securities are originally recorded at cost, which includes any brokerage commissions. To illustrate, assume that Foster Corporation purchases as a short-term investment 4,000 shares of *The Coca-Cola Company* on December 1. Foster paid \$48.98 per share, plus a brokerage commission of \$80. The entry to record the purchase of these shares is as follows.

Marketable Securities .....	196,000	
Cash .....		196,000
Purchased 4,000 shares of Coca-Cola capital stock. Total cost \$196,000 (\$48.98 × 4,000 shares + \$80); cost per share, \$49 (\$196,000 ÷ 4,000 shares).		

Marketable Securities is a control account used to report *all* of a company's short-term investments. If Foster Corporation invests in other companies, it will make an entry similar to the one shown; however, it will also create a marketable securities subsidiary ledger to maintain a separate record of each security owned.

Notice that the \$49 cost per share computed in the explanation of the given journal entry includes a portion of the total brokerage commission. The \$49 per share cost basis will be used in computing any gains or losses when Foster Corporation sells these securities.

### RECOGNITION OF INVESTMENT REVENUE

Entries to recognize interest and dividend revenue typically involve a debit to Cash and a credit to either Interest Revenue or Dividend Revenue. To illustrate, assume that on December 15, Foster Corporation receives a \$0.30 per share dividend on its 4,000 shares of Coca-Cola. The entry to record this receipt is as follows.

Cash .....	1,200	
Dividend Revenue .....		1,200
Received a quarterly dividend on shares of Coca-Cola capital stock (\$0.30 per share × 4,000 shares).		

Dividend and interest revenue is reported in the income statement as a component of a company's net income. It most often appears near the bottom of the income statement in the computation of income before taxes. The reporting of investment revenue is discussed further in Chapter 11.

### SALE OF INVESTMENTS

When an investment is sold, a gain or a loss often results. If an investment is sold for more than its cost basis a **gain** is recorded, whereas selling an investment for an amount less than its cost basis results in a **loss**. These items appear in the Other Income/Expense section of the income statement.

**Investments Sold at a Gain** To illustrate, assume that Foster Corporation sells 500 shares of its Coca-Cola stock on December 18 for \$50.04 per share, less a \$20 brokerage commission. Recall that Foster's cost basis, as computed on December 1, is \$49 per share. Thus, the entry to record the sale and the \$500 gain is as follows.

## Accounting for Marketable Securities

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Cash .....	25,000	
Marketable Securities .....		24,500
Gain on Sale of Investments .....		500
Sold 500 shares of Coca-Cola stock at a gain:		
Sale proceeds ( $\$50.04 \times 500$ shares - \$20 commission) .....	\$25,000	
Cost basis ( $\$49 \times 500$ shares) .....	<u>24,500</u>	
Gain on sale .....	\$ 500	

This transaction results in a gain because Foster Corporation sold the shares at an amount above their cost basis. The gain on the sale increases the company's net income for the period and is reported in the income statement in similar fashion to interest and dividend revenue. At the end of the period, the credit balance in the Gain on Sale of Investments account is closed to the Income Summary account, along with the credit balances of the other revenue accounts.

**Investments Sold at a Loss** Assume that Foster Corporation sells an additional 2,500 shares of its Coca-Cola stock on December 27 for \$48.01 per share, less a \$25 brokerage commission. The entry to record the sale and the \$2,500 loss is recorded as follows.

Cash .....	120,000	
Loss on Sale of Investments .....	2,500	
Marketable Securities .....		122,500
Sold 2,500 shares of Coca-Cola stock at a loss:		
Cost basis ( $\$49 \times 2,500$ shares) .....	\$122,500	
Sale proceeds ( $\$48.01 \times 2,500$ shares - \$25 commission) .....	<u>120,000</u>	
Loss on sale .....	\$ 2,500	

This loss reduces Foster Corporation's net income and is reported near the bottom of the income statement. The debit balance in the Loss on Sale of Investments account is closed to the Income Summary account at the end of the period, along with the debit balances of the other expense accounts.

## ADJUSTING MARKETABLE SECURITIES TO MARKET VALUE

Securities classified as available for sale are presented in the balance sheet at their *current market value* as of the balance sheet date. Hence, this valuation principle is often called **fair value accounting**. The adjustment of marketable securities to their current market value requires the use of an account entitled **Unrealized Holding Gain (or Loss) on Investments**. This account appears as a stockholders' equity item in the balance sheet.<sup>4</sup>

To illustrate, let us assume that Foster Corporation's 1,000 remaining shares of Coca-Cola capital stock have a current market value of \$47,000 on December 31 (1,000 shares at a market price of \$47 per share). Prior to any adjustment, the company's Marketable Securities account has a balance of \$49,000 (1,000 shares at \$49 per share). Thus, Foster Corporation must make the following fair value adjustment on December 31.

Unrealized Holding Loss on Investments .....	2,000	
Marketable Securities .....		2,000

To adjust the balance sheet valuation of marketable securities from \$49,000 (1,000 shares  $\times$  \$49) to the December 31 market value of \$47,000 (1,000 shares  $\times$  \$47).

<sup>4</sup> Unrealized holding gains and losses are often combined with other activities and reported in a stockholders' equity account entitled Accumulated Other Comprehensive Income. Comprehensive income is discussed in Chapter 12.

Exhibit 7-5 illustrates Foster Corporation's condensed balance sheet following its marketable securities valuation adjustment.

**EXHIBIT 7-5**  
Presentation of Marketable Securities in the Balance Sheet

FOSTER CORPORATION BALANCE SHEET DECEMBER 31, CURRENT YEAR		Liabilities & Stockholders' Equity	
<b>Assets</b>		<b>Liabilities:</b>	
<b>Current assets:</b>		(Detail not shown) . . . . . \$350,000	
Cash . . . . .	\$ 50,000		
Marketable securities (cost, \$49,000; market value, \$47,000) . . . . .	47,000	<b>Stockholders' equity:</b>	
Accounts receivable . . . . .	23,000	Capital stock . . . . .	\$400,000
Total current assets . . . . .	\$120,000	Retained earnings . . . . .	152,000
Other assets:		Unrealized holding loss on investments . . . . .	(2,000)
(Detail not shown) . . . . .	\$780,000	Total stockholders' equity . . . . .	\$550,000
Total . . . . .	\$900,000	Total . . . . .	\$900,000

Although the \$49,000 cost of Foster Corporation's marketable securities is disclosed in the balance sheet, the \$47,000 market value is used in the computation of total assets. The difference between the cost and market value also appears as an element of stockholders' equity, entitled Unrealized Holding Loss on Investments. When the market value of investment falls below cost, as in the case just presented, this special equity account is a *subtraction* from equity, representing a holding *loss*. But if the market value is *above* cost, this account is an *addition* to equity, representing a holding *gain*. Thus, if Foster's 1,000 shares of Coca-Cola had a market value on December 31 of \$51 per share, the investment would have been reported in the asset section of the balance sheet at \$51,000, and the stockholders' equity section of the balance sheet would have included the addition of a \$2,000 unrealized holding gain on investments.

Unrealized holding gains and losses are *not* subject to income taxes. Income taxes are levied only upon realized gains and losses recognized when investments are sold. Nonetheless, unrealized holding gains and losses are actually reported in the balance sheet net of expected future income tax effects. The computation of future tax effects is beyond the scope of our introductory discussion and is addressed in more advanced accounting courses. In the assignment material at the end of this chapter, unrealized holding gains and losses simply represent the difference between the cost and the current market value of the securities owned.



### INTERNATIONAL CASE IN POINT

In the United States only equity investments (stock) that are traded on a stock exchange can be carried at fair value. Equity investments not traded on a stock exchange must be carried at cost. Under International Financial Reporting Standards all available-for-sale securities, including unlisted equity investments, are carried at fair value.

## Accounts Receivable

One of the key factors underlying the growth of the American economy is the trend toward selling goods and services on credit. Accounts receivable comprise the largest financial asset of many merchandising companies.

Accounts receivable are relatively liquid assets, usually converting into cash within a period of 30 to 60 days. Therefore, accounts receivable from customers usually appear in the balance sheet immediately after cash and short-term investments in marketable securities.

## Accounts Receivable

In Chapter 5, we explained that assets capable of being converted quickly into cash are classified in the balance sheet as current assets. The period used to define current assets is typically one year or the company's operating cycle, whichever is longer. The operating cycle was defined in Chapter 6 as the normal period of time required to convert cash into inventory, inventory into accounts receivable, and accounts receivable back into cash. Some companies sell merchandise on long-term installment plans that require accounts receivable be outstanding for 12, 24, or even 48 months before being collected. These receivables are part of the company's normal operating cycle. Therefore, *all* accounts receivable arising from normal sales activity are generally classified as current assets, even if the credit terms extend beyond one year.

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## INTERNAL CONTROL OVER RECEIVABLES

Internal control over receivables is designed to ensure that only valid (legitimate) customer orders are recorded as both a receivable and revenue, and that all shipments of goods during the period are recorded. In addition, internal control over receivables should ensure that the sale transaction is recorded for the correct dollar amount, in the correct general ledger account, and in the correct period (i.e., that transactions near period-end are recorded in the accounting period in which the goods are shipped). Moreover, effective internal control ensures that credit is only extended to customers that meet the company's credit standards. Finally, internal control over receivables is designed to ensure that cash collections from customers are promptly deposited, that the payment is applied to the correct customer account, and that the cash collection is recorded in the accounting records.

The major steps in achieving internal control over accounts receivable and the resulting cash collections include the following.

- The Customer Order department prepares a sales order upon receipt of an order. The sales order describes the goods ordered (e.g., inventory number, units ordered, unit prices, and payment terms).
- The Credit department reviews the sales order and the customer's credit file and decides whether and how much credit should be extended.
- The Shipping department ensures that the goods shipped match those ordered by the customer.
- The Billing department compares what was shipped with what was ordered and prepares and mails a sales invoice.
- The Accounting department records the sale by debiting Accounts Receivable and crediting Sales, and by debiting Cost of Goods Sold and crediting Inventory (assuming a perpetual inventory system is used). In addition, an entry is made to reflect the credit sale in the Accounts Receivable subsidiary ledger.
- If customer payments are received by mail, checks are restrictively endorsed for deposit to the company's bank account and a daily listing of checks received is prepared (check number, party issuing the check, and check amount).
- The Cash Receipts department receives the checks and the mailroom listing of checks received and prepares the daily bank deposit.
- The Accounting department records the cash collection by debiting Cash and crediting Accounts Receivable. In addition, an entry is made to reflect the cash collection in the Accounts Receivable subsidiary ledger.<sup>5</sup>

LO7-5

**LEARNING OBJECTIVE**  
Describe internal controls over accounts receivable.

## UNCOLLECTIBLE ACCOUNTS

We have stated that accounts receivable are shown in the balance sheet at the estimated collectible amount—called *net realizable value*. No business wants to sell merchandise on account to customers who will be unable to pay. Nonetheless, if a company makes credit sales to hundreds—perhaps thousands—of customers, some accounts inevitably will turn out to be uncollectible.

A limited amount of uncollectible accounts is not only expected—it is evidence of a sound credit policy. If the credit department is overly cautious, the business may lose many sales opportunities by rejecting customers who should have been considered acceptable credit risks.

LO7-6

**LEARNING OBJECTIVE**  
Account for uncollectible receivables using the allowance and direct write-off methods.

<sup>5</sup> This description of internal control over sales, receivables, and cash collections is a high-level summary. More specificity is provided in future courses, particularly Accounting Information Systems and Auditing.

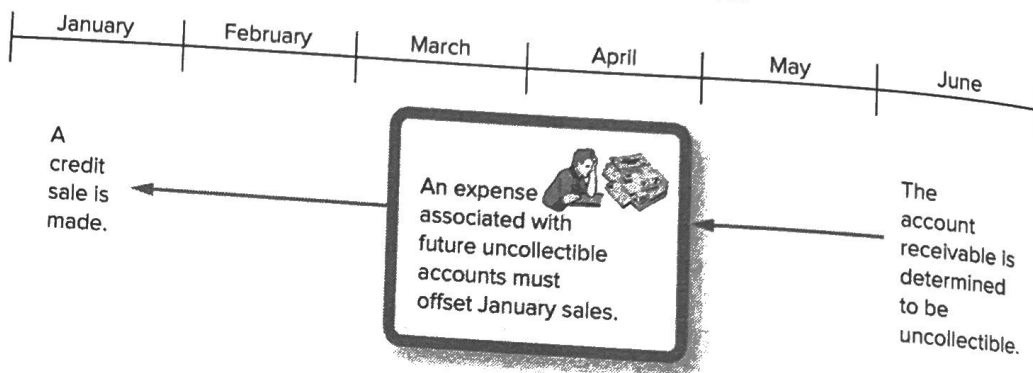
**Reflecting Uncollectible Accounts in the Financial Statements**

An account receivable that has been determined to be uncollectible is no longer an asset. The loss of this asset represents an *expense*, termed Uncollectible Accounts Expense.

In measuring business income, one of the most fundamental principles of accounting is that revenue should be *matched* with (offset by) the expenses incurred in generating that revenue. Uncollectible accounts expense is caused by selling goods on credit to customers who fail to pay their bills. Therefore, this expense is estimated and recorded in the time period in which the related sales are made, even though specific accounts receivable may not be determined to be uncollectible until a later accounting period. Thus an account receivable that originates from a credit sale in January and is determined to be uncollectible in June represents an expense in January. Exhibit 7-6 illustrates how uncollectible accounts expense is matched to revenue in the period in which the credit sale is made.

**EXHIBIT 7-6**

**Matching Uncollectible Accounts Expense to the Period in Which the Credit Sale Is Made**



To illustrate the matching process, assume that World Famous Toy Co. begins business on January 1, 2018, and makes most of its sales on account. At January 31, accounts receivable amount to \$250,000. On this date, the credit manager reviews the accounts receivable and estimates that approximately \$10,000 of these accounts will prove to be uncollectible. The following adjusting entry should be made at January 31.

**ALLOE** Provision for uncollectible accounts

Uncollectible Accounts Expense .....	10,000	
Allowance for Doubtful Accounts .....		10,000
To record the portion of total accounts receivable estimated to be uncollectible.		

The Uncollectible Accounts Expense account created by the debit part of this entry is closed into the Income Summary account in the same manner as any other expense account. The Allowance for Doubtful Accounts that was credited in the previous journal entry appears in the balance sheet as a deduction from the face amount of the accounts receivable. It reduces the accounts receivable to their net realizable value in the balance sheet, as shown in Exhibit 7-7.

**EXHIBIT 7-7**  
**Reporting Accounts Receivable at Estimated Net Realizable Value**

WORLD FAMOUS TOY CO. PARTIAL BALANCE SHEET JANUARY 31, 2018		
<b>Current assets:</b>		
Cash and cash equivalents .....		\$ 75,000
Marketable securities .....		25,000
Accounts receivable .....	\$250,000	
Less: Allowance for doubtful accounts .....	10,000	240,000
Inventory .....		300,000
<b>Total current assets .....</b>		<b>\$640,000</b>