CHAPTER 7  CASH AND RECEIVABLES

This IFRS Supplement provides expanded discussions of accounting guidance under International Financial Reporting Standards (IFRS) for the topics in Intermediate Accounting. The discussions are organized according to the chapters in Intermediate Accounting (13th or 14th Editions) and therefore can be used to supplement the U.S. GAAP requirements as presented in the textbook. Assignment material is provided for each supplement chapter, which can be used to assess and reinforce student understanding of IFRS.

BANK OVERDRAFTS

Bank overdrafts occur when a company writes a check for more than the amount in its cash account. Companies should report bank overdrafts in the current liabilities section, adding them to the amount reported as accounts payable. If material, companies should disclose these items separately, either on the face of the statement of financial position or in the related notes.\(^1\)

Bank overdrafts are included as a component of cash if such overdrafts are repayable on demand and are an integral part of a company’s cash management (such as the common practice of establishing offsetting arrangements against other accounts at the same bank). \([1]\) Overdrafts not meeting these conditions should be reported as a current liability.

IMPAIRMENT EVALUATION PROCESS

For many companies, making appropriate allowances for bad debts is relatively straightforward. The IASB, however, provides detailed guidelines to be used to assess whether receivables should be considered uncollectible (often referred to as impaired). Companies assess their receivables for impairment each reporting period and start the impairment assessment by considering whether objective evidence indicates that one or more loss events have occurred. Examples of possible loss events are:

1. Significant financial problems of the customer.
2. Payment defaults.
3. Renegotiation of terms of the receivable due to financial difficulty of the customer.
4. Measurable decrease in estimated future cash flows from a group of receivables since initial recognition, although the decrease cannot yet be identified with individual assets in the group.

A receivable is considered impaired when a loss event indicates a negative impact on the estimated future cash flows to be received from the customer. \([2]\)

The IASB requires that the impairment assessment should be performed as follows.

1. Receivables that are individually significant should be considered for impairment separately. If impaired, the company recognizes it. Receivables that are not individually significant may also be assessed individually, but it is not necessary to do so.

\(^1\)Bank overdrafts usually occur because of a simple oversight by the company writing the check. Banks often expect companies to have overdrafts from time to time and therefore negotiate a fee as payment for this possible occurrence. However, at one time, E.F. Hutton (USA) (a large brokerage firm) began intentionally overdrawing its accounts by astronomical amounts—on some days exceeding $1 billion—thus obtaining interest-free loans that it could invest. Because the amounts were so large and fees were not negotiated in advance, E.F. Hutton came under criminal investigation for its actions.
2. Any receivable individually assessed that is not considered impaired should be included with a group of assets with similar credit-risk characteristics and collectively assessed for impairment.

3. Any receivables not individually assessed should be collectively assessed for impairment.

To illustrate, assume that Hector Company has the following receivables classified into individually significant and all other receivables.

<table>
<thead>
<tr>
<th>Individually significant receivables</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Yaan Company</td>
<td>$40,000</td>
</tr>
<tr>
<td>Randon Inc.</td>
<td>100,000</td>
</tr>
<tr>
<td>Fernando Co.</td>
<td>60,000</td>
</tr>
<tr>
<td>Blanchard Ltd.</td>
<td>50,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>All other receivables</th>
<th>$250,000</th>
</tr>
</thead>
</table>

Hector determines that Yaan’s receivable is impaired by $15,000, and Blanchard’s receivable is totally impaired. Both Randon’s and Fernando’s receivables are not considered impaired. Hector also determines that a composite rate of 2% is appropriate to measure impairment on all other receivables. The total impairment is computed as follows.

<table>
<thead>
<tr>
<th>Accounts Receivable Impairments</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Individually assessed receivables</td>
<td></td>
</tr>
<tr>
<td>Yaan Company</td>
<td>$15,000</td>
</tr>
<tr>
<td>Blanchard Ltd.</td>
<td>50,000</td>
</tr>
<tr>
<td>Collectively assessed receivables</td>
<td>$500,000</td>
</tr>
<tr>
<td>Add: Randon Co.</td>
<td>100,000</td>
</tr>
<tr>
<td>Fernando Co.</td>
<td>60,000</td>
</tr>
<tr>
<td>Total collectively assessed receivables</td>
<td>$660,000</td>
</tr>
<tr>
<td>Collectively assessed impairments ($660,000 × 2%)</td>
<td>13,200</td>
</tr>
<tr>
<td>Total impairment</td>
<td>$78,200</td>
</tr>
</tbody>
</table>

Hector therefore has an impairment related to its receivables of $78,200. The most controversial part of this computation is that Hector must include in the collective assessment the receivables from Randon and Fernando that were individually assessed and not considered impaired. The rationale for including Randon and Fernando in the collective assessment is that companies often do not have all the information at hand to make an informed decision for individual assessments.

**Derecognition of Receivables**

At what point should a receivable no longer be included as an asset of a company like Unilever (NLD)—that is, derecognized? One situation occurs when the receivable no longer has any value—that is, the contractual rights to the cash flows of the receivable no longer exist. For example, if Unilever has a receivable from a customer who declares bankruptcy, the value of this receivable has expired. Similarly, when Unilever collects a receivable when due, it removes this receivable from its books. In both cases, Unilever no longer has any contractual rights to these receivables. As a result, the receivable is derecognized.

A second situation often occurs if Unilever transfers (e.g., sells) a receivable to another company, thereby transferring the risks and rewards of ownership to this other company. As an example, if Garcia Company sells its receivables to Holt Inc. and transfers all the risks and rewards of ownership to Holt, the receivable is derecognized. Although this guideline is straightforward, it is sometimes difficult to assess whether
some or all of the risks and rewards of ownership are transferred. The following discussion highlights the key issues related to transfers of receivables.

**Transfers of Receivables**

There are various reasons for the transfer of receivables to another party. For example, in order to accelerate the receipt of cash from receivables, companies may transfer receivables to other companies for cash. In addition, for competitive reasons, providing sales financing for customers is virtually mandatory in many industries. In the sale of durable goods, such as automobiles, trucks, industrial and farm equipment, computers, and appliances, most sales are on an installment contract basis. Many major companies in these industries have created wholly-owned subsidiaries specializing in receivables financing. For example, Ford Motor (USA) has Ford Motor Credit (USA), and John Deere (USA) has John Deere Credit (USA).

Second, the holder may sell receivables because money is tight and access to normal credit is unavailable or too expensive. Also, a firm may sell its receivables, instead of borrowing, to avoid violating existing lending agreements.

Finally, billing and collection of receivables are often time-consuming and costly. U.S. credit card companies such as MasterCard, Visa, American Express, Diners Club, and Discover take over the collection process and provide merchants with immediate cash.

Conversely, some purchasers of receivables buy them to obtain the legal protection of ownership rights afforded a purchaser of assets versus the lesser rights afforded a secured creditor. In addition, banks and other lending institutions may need to purchase receivables because of legal lending limits. That is, they cannot make any additional loans but they can buy receivables and charge a fee for this service.

The transfer of receivables to a third party for cash happens in one of two ways:

1. Secured borrowing.
2. Sales of receivables.

**Secured Borrowing**

A company often uses receivables as collateral in a borrowing transaction. In fact, a creditor often requires that the debtor designate (assign) or pledge receivables as security for the loan. If the loan is not paid when due, the creditor can convert the collateral to cash—that is, collect the receivables.

To illustrate, on March 1, 2011, Howat Mills, Inc. provides (assigns) $700,000 of its accounts receivable to Citizens Bank as collateral for a $500,000 note. Howat Mills continues to collect the accounts receivable; the account debtors are not notified of the arrangement. Citizens Bank assesses a finance charge of 1 percent of the accounts receivable and interest on the note of 12 percent. Howat Mills makes monthly payments to the bank for all cash it collects on the receivables. Illustration 7-2 shows the entries for the secured borrowing for Howatt Mills and Citizens Bank.

In addition to recording the collection of receivables, Howat Mills must recognize all discounts, returns and allowances, and bad debts. Each month Howat Mills uses the proceeds from the collection of the accounts receivable to retire the note obligation. In addition, it pays interest on the note.3

**Sales of Receivables**

Sales of receivables have increased substantially in recent years. A common type is a sale to a factor. Factors are finance companies or banks that buy receivables from

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2If a company transfers the receivables for custodial purposes, the custodial arrangement is often referred to as a pledge.

3What happens if Citizens Bank collected the transferred accounts receivable rather than Howat Mills? Citizens Bank would simply remit the cash proceeds to Howat Mills, and Howat Mills would make the same entries shown in Illustration 7-2. As a result, Howat Mills reports these “collaterized” receivables as an asset on the statement of financial position. The point here is that the risks and rewards of ownership have not been transferred to Citizens Bank.
Credit cards like MasterCard and Visa are a type of factoring arrangement. Typically, the purchaser of the receivables charges a $\frac{3}{4}–1\frac{1}{2}$ percent commission of the receivables purchased (the commission is 4–5 percent for credit card factoring).

Factoring receivables is traditionally associated with the textile, apparel, footwear, furniture, and home furnishing industries. Illustration 7-3 shows a typical factoring arrangement.

Illustration 7-3
Basic Procedures in Factoring

4Credit cards like MasterCard and Visa are a type of factoring arrangement. Typically, the purchaser of the receivable charges a $\frac{3}{4}–1\frac{1}{2}$ percent commission of the receivables purchased (the commission is 4–5 percent for credit card factoring).
Sale without Guarantee

When buying receivables, the purchaser generally assumes the risk of collectibility and absorbs any credit losses. A sale of this type is often referred to as a sale without guarantee (without recourse) against credit loss. The transfer of receivables in this case is an outright sale of the receivables both in form (transfer of title) and substance (transfer of risks and rewards). As in any sale of assets, the seller debits Cash for the proceeds and credits Accounts Receivable for the face value of the receivables. The seller recognizes the difference, reduced by any provision for probable adjustments (discounts, returns, allowances, etc.), as a Loss on the Sale of Receivables. The seller uses a Due from Factor account (reported as a receivable) to account for the proceeds retained by the factor to cover probable sales discounts, sales returns, and sales allowances.

To illustrate, Crest Textiles, Inc. factors €500,000 of accounts receivable with Commercial Factors, Inc., on a non-guarantee (or without recourse) basis. Crest Textiles transfers the receivable records to Commercial Factors, which will receive the collections. Commercial Factors assesses a finance charge of 3 percent of the amount of accounts receivable and retains an amount equal to 5 percent of the accounts receivable (for probable adjustments). Crest Textiles and Commercial Factors make the following journal entries for the receivables transferred without guarantee.

<table>
<thead>
<tr>
<th>Crest Textiles, Inc.</th>
<th>Commercial Factors, Inc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts (Notes) Receivable 500,000</td>
</tr>
<tr>
<td>Due from Factor</td>
<td>Due to Crest Textiles 25,000</td>
</tr>
<tr>
<td>Loss on Sale of Receivables</td>
<td>Financing Revenue 15,000</td>
</tr>
<tr>
<td>Accounts (Notes) Receivable 500,000</td>
<td>Cash 460,000</td>
</tr>
<tr>
<td><em>(5% \times €500,000)</em></td>
<td><strong>(3% \times €500,000)</strong></td>
</tr>
</tbody>
</table>

In recognition of the sale of the receivables, Crest Textiles records a loss of €15,000. The factor’s net income will be the difference between the financing revenue of €15,000 and the amount of any uncollectible receivables.

Sale with Guarantee

To illustrate a sale of receivables with guarantee (with recourse) against credit loss, assume that Crest Textiles issues a guarantee to Commercial Factors to compensate Commercial Factors for any credit losses on receivables transferred. In this situation, the question is whether the risks and rewards of ownership are transferred to Commercial Factors or remain with Crest Textile. In other words, is it to be accounted for as a sale or a borrowing?

In this case, given that there is a guarantee for all defaults, it appears that the risks and rewards of these receivables still remain with Crest Textiles. As a result, the transfer is considered a borrowing—sometimes referred to as a failed sale. Crest Textiles continues to recognize the receivable on its books, and the transaction is treated as a borrowing.\(^5\)

Assuming the same information as in Illustration 7-4, the journal entries for both Crest Textiles and Commercial Factors are shown in Illustration 7-5.

<table>
<thead>
<tr>
<th>Crest Textiles</th>
<th>Commercial Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 460,000</td>
<td>Due to Commercial Receivable 500,000</td>
</tr>
<tr>
<td>Due from Factor 25,000</td>
<td>Due to Crest Textiles 25,000</td>
</tr>
<tr>
<td>Finance Charge 15,000</td>
<td>Finance Revenue 15,000</td>
</tr>
<tr>
<td>Liability to Commercial Factor 500,000</td>
<td>Cash 460,000</td>
</tr>
</tbody>
</table>

\(^5\)In general, IFRS does not allow netting of assets and liabilities unless there is an explicit right of set-off. [3] Thus, Crest Textiles reports both a receivable and a liability of €500,000 in its statement of financial position.
In this case, Crest Textiles records a liability to Commercial Factors. Commercial Factors records an Accounts Receivable from Crest Textiles. That is, the accounting for a failed sale is similar to that for a secured borrowing. As the transferred receivables are collected, the Liability to Commercial Factors on the books of Crest Textiles is reduced. Similarly, on the books of Commercial Factors, the accounts receivable from Crest Textiles is also reduced.

**Summary of Transfers**

The IASB uses the term *derecognition* when referring to the accounting for transfers of receivables. According to the IASB, determining whether receivables that are transferred can be derecognized and accounted for as a sale is based on an evaluation of whether the seller has transferred substantially all the risks and rewards of ownership of the financial asset. Illustration 7-6 summarizes the accounting guidelines for transfers of receivables. [4]

![Illustration 7-6](image)

As indicated, if substantially all the risks and rewards of ownership of the receivable are transferred, then it is derecognized. However, if substantially all of the risks and rewards are not transferred, then the company treats the transfer as a secured borrowing. If sale accounting is appropriate, a company must still consider assets obtained and liabilities incurred in the transaction (e.g., a guarantee). [5]

**IMPAIRMENT MEASUREMENT AND REPORTING**

As indicated, companies assess their receivables for impairment each reporting period. Companies start the impairment assessment by considering whether objective evidence indicates that one or more loss events have occurred. Examples of possible loss events

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[4] In some situations, a company may continue to hold the receivables but does not retain substantially all the risks and rewards of the receivable. In this case, the company must determine whether it has retained control of the receivable. The primary indicator that the company has control of an asset is if it can sell the asset. If control has not been retained, the asset is derecognized and sale accounting is applied. In all other cases, the company has retained control and the arrangement is accounted for as a secured borrowing.
are significant financial problems of the customer, payment defaults, or renegotiation of terms of the receivable due to financial difficulty of the customer. A receivable is considered impaired when a loss event has a negative impact on the future cash flows to be received from the customer. The percentage-of-sales and receivables approaches are examples of impairment testing using the collective assessment approach. Here, we discuss impairments based on the individual assessment approach for long-term receivables.

If a receivable is determined to be individually impaired, the company should measure the loss due to the impairment. This impairment loss is calculated as the difference between the carrying amount (generally the principal plus accrued interest) and the expected future cash flows discounted at the loan’s historical effective-interest rate. When using the historical effective loan rate, the value of the investment will change only if some of the legally contracted cash flows are reduced. A company recognizes a loss in this case because the expected future cash flows are now lower. The company ignores interest rate changes caused by current economic events that affect the fair value of the loan. In estimating future cash flows, the creditor should use reasonable and supportable assumptions and projections.

Impairment Loss Example

At December 31, 2010, Ogden Bank recorded an investment of $100,000 in a loan to Carl King. The loan has an historical effective-interest rate of 10 percent, the principal is due in full at maturity in three years, and interest is due annually. Unfortunately, King is experiencing significant financial difficulty and indicates that he will have a difficult time making full payment. The loan officer performs a review of the loan’s expected future cash flows and utilizes the present value method for measuring the required impairment loss. Illustration 7-7 shows the cash flow schedule prepared by the loan officer.

<table>
<thead>
<tr>
<th>Dec. 31</th>
<th>Contractual Cash Flow</th>
<th>Expected Cash Flow</th>
<th>Loss of Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>$10,000</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>2012</td>
<td>10,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>2013</td>
<td>$110,000</td>
<td>105,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Total cash flows</td>
<td>$130,000</td>
<td>$115,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

As indicated, this loan is impaired. The expected cash flows of $115,000 are less than the contractual cash flows, including principal and interest, of $130,000. The amount of the impairment to be recorded equals the difference between the recorded investment of $100,000 and the present value of the expected cash flows, as shown in Illustration 7-8.

<table>
<thead>
<tr>
<th>Recorded investment</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Present value of $100,000 due in 3 years at 10%</td>
<td></td>
</tr>
<tr>
<td>(Table 6-2); FV(PVF$$_{3,10%}$$); ($100,000 × 0.75132)</td>
<td>$75,132</td>
</tr>
<tr>
<td>Present value of $5,000 interest receivable annually for 3 years at 10% R(PVF-OA$$_{3,10%}$$); ($5,000 × 2.48685)</td>
<td>12,434</td>
</tr>
<tr>
<td>Loss on impairment</td>
<td>$12,434</td>
</tr>
</tbody>
</table>

The loss due to the impairment is $12,434. Why isn’t it $15,000 ($130,000 − $115,000)? Because Ogden Bank must measure the loss at a present value amount, not at an undiscounted amount, when it records the loss.
**Recording Impairment Losses**

Ogden Bank (the creditor) recognizes an impairment loss of $12,434 by debiting Bad Debt Expense for the expected loss. At the same time, it reduces the overall value of the receivable by crediting Allowance for Doubtful Accounts. The journal entry to record the loss is therefore as follows.7

\[
\begin{array}{ccc}
\text{Bad Debt Expense} & 12,434 \\
\text{Allowance for Doubtful Accounts} & 12,434 \\
\end{array}
\]

**Recovery of Impairment Loss**

Subsequent to recording an impairment, events or economic conditions may change such that the extent of the impairment loss decreases (e.g., due to an improvement in the debtor’s credit rating). In this situation, some or all of the previously recognized impairment loss shall be reversed either directly, with a debit to Accounts Receivable, or by debiting the allowance account and crediting Bad Debt Expense.

To illustrate, assume that in the year following the impairment recorded by Ogden, Carl King has worked his way out of financial difficulty. Ogden now expects to receive all payments on the loan according to the original loan terms. Based on this new information, the present value of the expected payments is $100,000. Thus, Ogden makes the following entry to reverse the previously recorded impairment.

\[
\begin{array}{ccc}
\text{Allowance for Doubtful Accounts} & 12,434 \\
\text{Bad Debt Expense} & 12,434 \\
\end{array}
\]

Note that the reversal of impairment losses shall not result in a carrying amount of the receivable that exceeds the amortized cost that would have been reported had the impairment not been recognized.8

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7In the event of a receivable write-off, the company charges the loss against the allowance.

In subsequent periods, if revising estimated expected cash flows based on new information, the company adjusts the allowance account and bad debt expense account (either increased or decreased depending on whether conditions improved or worsened) in the same fashion as the original impairment. We use the terms “loss” and “bad debt expense” interchangeably throughout this discussion. Companies may charge losses related to receivables transactions to Bad Debt Expense or the related Allowance for Doubtful Accounts, because they use these accounts to recognize changes in values affecting receivables.

8What entry does Carl King (the debtor) make? The debtor makes no entry because he still legally owes $100,000.
QUESTIONS

1. Briefly describe the impairment evaluation process and assessment of receivables on an individual or collective basis.

2. What is the role of “risks and rewards” when accounting for a transfer of receivables?

3. Moon Hardware is planning to factor some of its receivables. The cash received will be used to pay for inventory purchases. The factor has indicated that it will require “full guarantee (with recourse)” on credit losses on the sold receivables. Explain to the controller of Moon Hardware what “full guarantee” on credit losses is and how the guarantee will be reflected in Moon’s financial statements after the sale of the receivables.

4. What are the general rules for measuring and recognizing an impairment of a receivable?

BRIEF EXERCISES

BE7-1 Wood Incorporated factored $150,000 of accounts receivable with Engram Factors Inc., without guarantee of credit loss. Engram assesses a 2% finance charge of the amount of accounts receivable and retains an amount equal to 6% of accounts receivable for possible adjustments. Prepare the journal entry for Wood Incorporated and Engram Factors to record the factoring of the accounts receivable to Engram.

BE7-2 Use the information in BE7-1 for Wood. Assume that the receivables are sold with recourse (guarantee). Prepare the journal entry for Wood to record the sale.

BE7-3 Assume that Toni Braxton Company has recently fallen into financial difficulties. By reviewing all available evidence on December 31, 2010, one of Toni Braxton’s creditors, the National Bank, determined that Toni Braxton would pay back only 65% of the principal at maturity. As a result, the bank decided that the loan was impaired. If the loss is estimated to be $225,000, what entry(ies) should National Bank make to record this loss?

EXERCISES

E7-1 (Impairments) On December 31, 2010, Iva Majoli Company borrowed €62,092 from Paris Bank, signing a 5-year, €100,000 zero-interest-bearing note. The note was issued to yield 10% interest. Unfortunately, during 2012, Majoli began to experience financial difficulty. As a result, at December 31, 2012, Paris Bank determined that it was probable that it would receive back only €75,000 at maturity. The market rate of interest on loans of this nature is now 11%.

Instructions
(a) Prepare the entry to record the issuance of the loan by Paris Bank on December 31, 2010.
(b) Prepare the entry, if any, to record the impairment of the loan on December 31, 2012, by Paris Bank.

E7-2 (Impairments) On December 31, 2010, Conchita Martinez Company signed a $1,000,000 note to Sauk City Bank. The market interest rate at that time was 12%. The stated interest rate on the note was 10%, payable annually. The note matures in 5 years. Unfortunately, because of lower sales, Conchita Martinez’s financial situation worsened. On December 31, 2012, Sauk City Bank determined that it was probable that the company would pay back only $600,000 of the principal at maturity. However, it was considered likely that interest would continue to be paid, based on the $1,000,000 loan.

Instructions
(a) Determine the amount of cash Conchita Martinez received from the loan on December 31, 2010.
(b) Prepare a note amortization schedule for Sauk City Bank up to December 31, 2012.
(c) Determine the loss on impairment that Sauk City Bank should recognize on December 31, 2012.
FINANCIAL REPORTING

Financial Reporting Problem
Marks and Spencer plc (M&S)
The financial statements of M&S can be accessed at the book’s companion website, www.wiley.com/college/kiesoifrs.

Instructions
Refer to M&S’s financial statements and the accompanying notes to answer the following questions.
(a) What criteria does M&S use to classify “Cash and cash equivalents” as reported in its statement of financial position?
(b) As of March 29, 2008, what balances did M&S have in cash and cash equivalents? What were the major uses of cash during the year?
(c) What amounts related to trade receivables does M&S report? Does M&S have any past due but not impaired receivables?

BRIDGE TO THE PROFESSION

Professional Research
As the new staff person in your company’s treasury department, you have been asked to conduct research related to a proposed transfer of receivables. Your supervisor wants the authoritative sources for the following items that are discussed in the securitization agreement.

Instructions
Access the IFRS authoritative literature at the IASB website (http://eifrs.iasb.org/). When you have accessed the documents, you can use the search tool in your Internet browser to prepare responses to the following items. (Provide paragraph citations.)
(a) Identify relevant IFRSs that address transfers of receivables.
(b) What are the objectives for reporting transfers of receivables?
(c) Provide definitions for the following:
   (1) Derecognition.
   (2) Amortized cost.
(d) Provide other examples (besides recourse and collateral) that qualify as continuing involvement.