2 Payment methods and the bank account balance

this chapter covers...

This chapter explains how the difference in timing of various payment methods can affect the balance of the bank account of a business. The topics covered include:

- *terminology used for business bank accounts*
- *the way in which a bank overdraft works*
- *the importance of looking after a business bank account balance*
- *the costs of running a bank account*
- *the financial implications of **good** management of the bank account*
- *the financial implications of **poor** management of the bank account*
- *the need for businesses **receiving** payments to make sure that they are paid into the account sooner rather than later*
- *the policy for businesses **making** payments so that they are deducted from the account later rather than sooner*

The payment methods discussed in this chapter include:

- *cash*
- *bank drafts*
- *electronic bank transfers (BACS, standing orders, direct debits, Faster Payments, CHAPS)*
- *debit cards*
- *cheques*
- *credit cards*

BUSINESS BANK ACCOUNTS – SOME TERMINOLOGY

current account – definition

A business 'current' account can be defined as:

an account with a financial institution such as a bank into which a business can pay money and from which it can make payments

debits and credits

The important rule to remember about a bank account is that the terms 'debit' and 'credit' are used very differently to 'debit' and 'credit' in double-entry bookkeeping. In fact they may seem to be 'the wrong way round'.

The rule for a bank account is:

- payments **into** a bank account are known as **credits**
- payments **out of** a bank account are called **debits**

This is the opposite to double-entry bookkeeping in the cash book of a business where a payment received is a debit (left-hand side of the cash book) and a payment made is a credit (right-hand side of the cash book).

debit and credit balances

A bank account normally has either a credit balance or a debit balance:

- a **credit balance** means that there is money available in the bank account; in other words there is a **positive** balance
- a **debit balance** results when there is no money available in the bank account; in this case there will be a **negative** balance and the customer owes money to the bank

OVERDRAFTS

There is nothing wrong about a business having a debit balance – it can in fact be very useful for a customer who needs financial assistance to have a debit (negative) balance on its current account by borrowing from the bank by means of an **overdraft**.

For example, a retail business might want to buy some stock which it knows will sell quickly and make a good profit. It may not have the money available at the time but knows that it can repay any borrowing within the next three months. The simplest way of raising the money in the short term is for the business to apply to its bank to authorise an **overdraft** on its current account.

the features of an overdraft

- an arrangement which will allow the business to go 'overdrawn' (ie have a debit balance) on its bank current account
- the authorisation from the bank will be for a certain period of time, eg 12 months, and can usually be renewed at the end of that period
- the overdraft will set an upper limit for the debit balance which can be outstanding at any one time – eg £25,000
- an authorised overdraft is likely to have a fluctuating balance and may 'swing' from a credit balance to a debit balance on the bank account and then back into credit again
- interest will be charged on a daily basis on the amount borrowed from the bank, ie on any debit balance
- a fee is normally payable when the overdraft is arranged in the first place and also when it is renewed

In short, an overdraft is a very flexible arrangement because the business customer can borrow whenever the money is needed and repay the borrowing when the money comes back into the business.

EFFICIENT BANK ACCOUNT MANAGEMENT

the costs of running a business bank account

Banks do not provide business bank accounts free of charge. Whether the balance is in credit or in debit there will be bank charges to pay.

It is in the interest of the business with a bank account with a debit balance (ie an overdraft) to 'manage' the account so that the cost to the business is kept to a minimum. The **normal** costs involved include:

- standard bank charges for running the account
- interest payable on overdrawn (debit) balances
- fees for setting up and renewing an overdraft

the results of poor account management

Sometimes a business bank account might go overdrawn **without the authorisation of the bank**. A common example of this is when a business is having financial problems. If this happens, the bank will send letters asking for repayment or even return ('bouncing') cheques that the customer has issued. All these will incur substantial **extra charges** for the business.

good practice in bank account management

Bearing all these account charges in mind it is good practice for a business to minimise costs as follows:

- keep the bank account in credit whenever possible
- if there is an authorised overdraft limit, keep the account within that limit
- **when receiving payments**: make sure that money received is paid into the account **sooner rather than later**
- **when making payments**: choose a payment method which results in the money being deducted from the account **later rather than earlier**

a note on paying 'later' rather than 'late'

Note that paying **later** rather than earlier does **not** mean delaying payment longer than is normally acceptable. Paying **late** could give the business a bad reputation and even result in a supplier withdrawing credit. For example, paying an invoice 30 days after the invoice date is fully acceptable if 30 days credit is allowed. Importantly, it will also provide the business with that amount of money for 30 days. But paying an invoice 60 days after the invoice date if 30 days credit is allowed is not normal practice.

TIMING OF PAYMENTS AND THE BANK BALANCE

If a business is to make the best use of various payment methods it must be familiar with the time it takes for each of them to be processed by the appropriate payment system.

The rest of this chapter deals with the timings associated with the payment methods included below. They are listed in order of how quickly the money for the payment will be deducted from the bank account.

- cash, bank drafts, CHAPS electronic bank transfer, Faster Payments
- BACS electronic bank transfers
- debit cards
- cheques
- credit cards

same-day deductions from the bank account

In order to keep the bank balance as high as possible for as long as possible, a business should make a same-day deduction for a payment on the latest possible date – within reason. Same-day deductions include:

- **cash**

  Any withdrawal of cash from the bank will be deducted from the account on the same day that the withdrawal is made. Examples of this include:

  – top-ups of **petty cash**, ie cash kept in the office and used for small expenses incurred by the business

  – payment of **wages** by employees who are paid in cash; this is also best done as late as possible because of the security risks of a business holding cash

- **bank draft**

  A bank draft – a bank 'cheque' which, unless it is forged or stolen, is seen to be as good as cash – will be deducted from the account on the day that it is issued. A bank draft is normally used for a large purchase.

- **CHAPS electronic bank transfer**

  The amount of a CHAPS electronic bank transfer (a same day bank-to-bank electronic transfer) will be deducted from the account on the day that the transfer is made. The amount is normally very large, eg paying for a property purchase.

- **Faster Payment**

  The time taken for this electronic money transfer made from one bank account to another is up to two hours, but can be as short as a few minutes. Payment can be:

  – a single payment made for the same day

  – a single payment authorised in advance for sending at a later date

  – a standing order (regular payments on fixed dates, spread over a period of time)

- **BACS direct credits and direct debits**

  The BACS electronic bank transfer system operates on the basis that instructions are set up in advance for payment from one account to another account three working days before the payments are made. Payment is taken from the payer's bank account on the same day that it is paid into the account of the person or business receiving it. In other words, it is a same day deduction which requires three working days' notice.

one day later deductions

- **debit card**

  Payment for a purchase made by debit card is normally taken from the bank account on the day following the transaction.

cheques and credit cards

There are many variations in the time it takes for a cheque to be deducted from the account of the payer. It depends on when and where the person receiving the cheque pays it into the bank. The following rules apply:

- **cheques paid in at the bank branch of the cheque issuer**

  If Business A gives a cheque to Business B on Monday and Business B pays it in at Business A's bank branch on Monday the money will be deducted from the account of Business A on the **same day**.

  The rule here is therefore:

  'cheque paid in at the cheque issuer's branch - same day payment'.

- **cheques paid in at a different bank or bank branch**

  If Business A gives a cheque to Business B on Monday and Business B pays it in at Business B's bank branch on Monday the money will be deducted from the account of Business A **three working days later**.

  The rule here is different:

  'cheque paid in at different branch - payment deducted three days later'.

  Because the great majority of cheques are paid in at a different branch from the issuer's branch, businesses writing out cheques can normally rely on at least the three working days delay before the money is deducted from their bank account.

- **cheques sent in the post**

  If Business A posts a cheque payment to Business B on Monday using second class post, the cheque may not get to Business B until the end of the week, or even the beginning of the following week. In using this payment method Business A will have the amount of the cheque in its bank account for at least an extra week.

- **cheques with technical errors**

  It may be that Business A issues a cheque with a technical error on it, for example:

  – Business A has forgotten to sign it

  – the amount in words and in figures is not the same

  In this case the cheque may be paid into the bank by Business B but then returned by the banking system to Business A asking for it to be corrected and sent again through the banking system, a process which will take at least a week. This will again mean that the payment has been made but the transfer of funds has been delayed with the result that Business A will have the extra funds on its bank account for that period.

- **credit cards**

  A company credit card is a popular way of enabling a business employee such as a sales rep to pay for business expenses as they are incurred, eg travel and entertaining customers.

  Payment for one month's expenses is normally made in one amount by direct debit during the following month, providing the business bank account with extra funds for the month up to the payment date.

A summary table showing the effect on the bank balance of various payment methods is shown below.

the effect of different payment methods on the bank account

payment method	payment process	effect on bank account
cash	notes and coins withdrawn from the bank	immediate reduction in balance
bank draft	'as good as cash' cheque issued by the bank	immediate reduction in balance
CHAPS payment	large amount electronic transfer by the bank	immediate reduction in balance
Faster Payment	electronic transfer processed by banks (used for immediate payments and also standing orders)	immediate reduction in balance
BACS payment	electronic transfer processed by BACS set up on BACS system 3 days before the actual money transfer (used for direct credits and direct debits)	reduction in balance on the same day that the transfer reaches the account receiving payment
debit card	card used for business expenses	money taken from the account on the next working day
cheque	payment relies on an issued cheque - being sent by the issuer to the recipient - being paid into a bank by the recipient - passing through the cheque clearing system - being technically correct - being paid by the issuer's bank and not 'bounced' (returned) by the issuer's bank	amount deducted from the bank account of the cheque issuer: it can be the same day (if the cheque is paid in at the issuer's bank branch), or a week or more depending on when it is paid in, and the efficiency of the postal service
credit card	card for paying for business expenses	monthly lump sum deduction of the previous month's expenses made on the card

Chapter Summary

- A business bank account will normally either have a positive balance (a 'credit' balance) or a negative balance (a 'debit balance').
- An overdraft is a bank current account which is authorised by the bank to have a negative (debit) balance which will provide short-term financing to a business.
- A bank which authorises a business overdraft will set a 'limit' up to which the business can borrow.
- A business will have to pay charges when an overdraft is set up or renewed and interest when the account goes overdrawn.
- A business should manage its bank account balance carefully by minimising costs such as interest and charges.
- Costs can be minimised by ensuring that money due to the business is paid into the bank account promptly.
- Payments out should be managed carefully taking into account the amount of time taken between making the payment and the day on which the money is deducted from the account.
- Payments out which are deducted from the account on the same day (eg cash, CHAPS, bank drafts) will immediately reduce the amount of money available on the account.
- Payment methods which involve a delay in the time it takes for the deduction from the bank account (eg cheques and credit cards) will temporarily provide money available on the account for use by the business.

Key Terms

current account	a basic bank account into which money can be paid and from which payments can be made
debit balance	a negative balance on a bank account; in effect the account holder is borrowing and owes the bank the money
credit balance	a positive balance on a bank account; in effect the bank owes the account holder money.
overdraft	an arrangement with a bank to allow short-term borrowing (a debit balance) on a current account
overdraft limit	the maximum amount which a bank will allow a customer to borrow on an overdraft
same day deduction	the situation where a payment made by a business is deducted from the bank account on the same day

Tutorial note: The key terms defining the various payment methods used are to be found in the previous chapter (page 13). The time intervals involved before the deductions are made from the bank account are set out in the right-hand column of the table on page 22 of this chapter.

Activities

2.1 Insert the words 'debit' or 'credit' in the correct boxes to complete the following two sentences:

(a) A bank calls an account with a positive balance a [ ] balance.

(b) A bank calls an account with a negative balance a [ ] balance.

2.2 Good practice in bank account management follows certain principles. Tick the correct option.

(a)	A bank account should be kept in credit whenever possible	
(b)	A bank account should be kept in debit whenever possible	

2.3 The following principle applies when paying money into a bank account. Tick the correct option.

(a) The money should be paid in as soon as possible	
(b) The money should be paid in at the end of the month	

2.4 The following principle applies when making payments from a bank account. Tick the correct option.

(a) The payment should be made as soon as possible	
(b) The payment should be made later rather than earlier, but not too late	

2.5 Different types of bank payment can take different periods of time before they are deducted from the bank account.

Choose the correct deduction periods (same day/next day/next month) for the different types of payment listed below. Tick the appropriate column in the table.

	Same day	**Next day**	**Next month**
(a) Debit card			
(b) Cash			
(c) CHAPS			
(d) Credit card			
(e) Faster Payment			

2.6 A business, Stokes Ltd, banks at Lloyds Bank, Dorchester. At a meeting on Monday a director of Stokes Ltd hands a cheque to the director of another business, Broad Ltd, to settle their account. Broad Ltd pays the cheque into its account with Barclays Bank, Dorchester, on the same day. Tick the day of that week on which the cheque will be deducted from the account of Stokes Ltd.

(a) Tuesday	
(b) Wednesday	
(c) Thursday	