BRIEF EXERCISE 8-1

(a) Other receivables.
(b) Notes receivable.
(c) Accounts receivable.

BRIEF EXERCISE 8-2

(a) Accounts Receivable ........................................ 23,000
    Sales Revenue ............................................... 23,000
(b) Sales Returns and Allowances .......................... 2,400
    Accounts Receivable ...................................... 2,400
(c) Cash ($20,600 – $412) .................................. 20,188
    Sales Discounts ($20,600 X 2%) ......................... 412
    Accounts Receivable ($23,000 – $2,400) .............. 20,600

BRIEF EXERCISE 8-3

(a) Allowance for Doubtful Accounts ..................... 4,300
    Accounts Receivable ...................................... 4,300

(b) (1) | Before Write-Off | (2) | After Write-Off |
      | Accounts receivable | $700,000 | $695,700 |
      | Less: Allowance for doubtful accounts | 25,000 | 20,700 |
      | Cash realizable value | $675,000 | $675,000 |
BRIEF EXERCISE 8-4

Accounts Receivable ........................................ 4,300
  Allowance for Doubtful Accounts ..................... 4,300

Cash ................................................................. 4,300
  Accounts Receivable ..................................... 4,300

BRIEF EXERCISE 8-5

(a) Bad Debts Expense
  [($400,000 \times 2\%) - $2,800] .......................... 5,200
  Allowance for Doubtful Accounts ...................... 5,200

(b) Bad Debts Expense
  [($400,000 \times 2\%) + $900] .......................... 8,900
  Allowance for Doubtful Accounts ...................... 8,900

BRIEF EXERCISE 8-6

Interest  Maturity Date
(a) $800  August 9
(b) $875  October 12
(c) $200  July 11

BRIEF EXERCISE 8-7

<table>
<thead>
<tr>
<th>Maturity Date</th>
<th>Annual Interest Rate</th>
<th>Total Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) May 31</td>
<td>9%</td>
<td>$9,000</td>
</tr>
<tr>
<td>(b) August 1</td>
<td>8%</td>
<td>$600</td>
</tr>
<tr>
<td>(c) September 7</td>
<td>10%</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

BRIEF EXERCISE 8-8

Jan. 10  Accounts Receivable .................................. 8,000
          Sales Revenue ......................................... 8,000

Feb. 9   Notes Receivable .................................... 8,000
          Accounts Receivable .................................. 8,000
BRIEF EXERCISE 8-9

(a) Bad Debts Expense ........................................... 18,000
    Allowance for Doubtful Accounts ......... 18,000

(b) Current assets
    Cash .............................................................. $ 90,000
    Accounts receivable ....................................... $400,000
    Less: Allowance for doubtful accounts ...... 18,000 382,000
    Inventory ...................................................... 180,000
    Supplies ....................................................... 13,000
    $665,000

(c) Receivables turnover ratio = \( \frac{\$3,000,000}{\$300,000} \) = 10 times

    Average collection period = \( \frac{365 \text{ days}}{10} \) = 36.5 days

    The receivables turnover ratio is a liquidity measure. The average collection period indicates the effectiveness of a company’s credit and collection policies. To evaluate Ketter’s liquidity and credit policies, these measures should be compared to the same measures for competitors.

BRIEF EXERCISE 8-10

Receivables Turnover Ratio:

\( \frac{$23.1B}{$3.2B + 3.25B} = \frac{$23.1B}{$3.225B} = 7.2 \text{ times} \)

Average Collection Period:

\( \frac{365 \text{ days}}{7.2 \text{ times}} = 50.7 \text{ days} \)
BRIEF EXERCISE 8-11

(a) Cash ($200 – $6) ........................................................... 194
Service Charge Expense ($200 X 3%) ......................... 6
Sales ................................................................................. 200

(b) Cash ($65,000 – $1,950) ............................................. 63,050
Service Charge Expense ($65,000 X 3%) .................. 1,950
Accounts Receivable .............................................. 65,000

BRIEF EXERCISE 8-12

<table>
<thead>
<tr>
<th>Accounts Receivable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beg.</td>
</tr>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>Collections</td>
</tr>
<tr>
<td>End</td>
</tr>
</tbody>
</table>

or

\[
\text{Sales} - \text{Increase in Receivables} = \text{Cash Collections}
\]

\[
\begin{align*}
\text{Sales} & = 598,000 \\
\text{Increase in Receivables} & = 91,000 - 70,000 = 21,000 \\
\text{Cash Collections} & = 577,000
\end{align*}
\]

Chapter Outline

Study Objective 1 - Identify the Different Types of Receivables

♦ The term receivables refers to amounts due from individuals and companies.

♦ Receivables are claims that are expected to be collected in cash.

♦ Receivables represent one of a company’s most liquid assets.

♦ Receivables are frequently classified as:
  ◦ Accounts receivable:
    • Are amounts customers owe on account.
    • Result from the sale of goods and services (often called trade receivables).
    • Are expected to be collected within 30 to 60 days.
    • Are usually the most significant type of claim held by a company.
  ◦ Notes receivable:
    • Represent claims for which formal instruments of credit are issued as evidence of debt.
    • Are credit instruments that normally require payment of interest and extend for time periods of 60-90 days or longer.
    • May result from sale of goods and services (often called trade receivables).
  ◦ Other receivables:
• Non-trade receivables including interest receivable, loans to company officers, advances to employees, and income taxes refundable.
• Generally classified and reported as separate items in the balance sheet.

Go over the following transactions and ask students to identify what type receivable would be increased—accounts receivable, a note receivable, or other receivables.

(1) The vice-president of manufacturing is sending his youngest child to a prestigious university and needs a loan of $25,000.
(2) A customer buys merchandise on account.
(3) A customer’s account receivable has been outstanding for some time and he is asked to sign a note for the amount of the balance.

Study Objective 2 - Explain how Accounts Receivable are Recognized in the Accounts

Two accounting issues associated with accounts receivable are:

1. Recognizing accounts receivable
2. Valuing accounts receivable
Recognizing accounts receivable

♦ **Service organizations**—A receivable is recorded when service is provided on account.
  ♦ Debit accounts receivable and credit service revenue

♦ **Merchandisers**—A receivable is recorded at the point of sale of merchandise on account.
  ♦ Debit accounts receivable and credit sales
  ♦ A receivable may be reduced by sales discounts and/or sales returns

Study Objective 3 - Describe the Methods Used to Account for Bad Debts

Valuing accounts receivable

♦ Determining the amount of accounts receivable to report is difficult because some receivables will become uncollectible.
  ♦ This creates **bad debts expense** – a normal and necessary risk of doing business on a credit basis.

Two methods are used in accounting for uncollectible accounts:
1. Direct Write-off Method
2. Allowance Method

♦ **Direct Write-Off Method**
  ■ When a specific account is determined to be uncollectible, the loss is charged to **Bad Debts Expense**.
  ■ For example, assume that Warden Co. writes off M. E. Doran’s $200 balance as uncollectible on December 12. The entry is:

    Dec. 12  Bad Debts Expense ................................................................. 200
             Accounts Receivable—M. E. Doran .................. 200
    (To record write-off of M. E. Doran account)

  ■ Bad debts expense will show only **actual losses** from uncollectibles.
  ■ Bad debts expense is often recorded in a period different from that in which the revenue was recorded.
  ■ Under this method, no attempt is made to:
    (1) match bad debts expense to sales revenue in the income statement.
    (2) show accounts receivable in the balance sheet at the amount actually expected to be received; and

  ■ Use of the direct write-off method can reduce the usefulness of both the income statement and balance sheet.
  ■ Unless bad debt losses are insignificant, the direct write-off method is not acceptable for financial reporting purposes.

Using the direct write-off method, entries to record write-offs are often made in a period following sales rather than in the period in which the sales were made. Therefore, there is no matching of expenses with the revenue the expenses help to produce.
Allowance Method

- **The allowance method** of accounting for bad debts involves estimating uncollectible accounts at the end of each period.
- It provides better matching of expenses and revenues on the income statement and ensures that receivables are stated at their **cash (net) realizable value** on the balance sheet.
- **Cash (net) realizable value** is the net amount of cash expected to be received. It excludes amounts that the company estimates it will not collect.
- Receivables are therefore reduced by estimated uncollectible amounts on the balance sheet through use of the allowance method.
- The allowance method is required for financial reporting purposes when bad debts are material.
- Three essential features of the allowance method are:
  1. Companies estimated uncollectible accounts receivable and match them against revenues in the same accounting period in which the revenues are recorded.
  2. Companies record estimated uncollectibles as an increase (a debit) to **Bad Debts Expense** and an increase (a credit) to **Allowance for Doubtful Accounts** (a contra asset account) through an adjusting entry at the end of each period.
  3. Companies debit actual uncollectibles to **Allowance for Doubtful Accounts** and credit them to **Accounts Receivable** at the time the specific account is written off as uncollectible.

Recording Estimated Uncollectibles

- Allowance for Doubtful Accounts shows the estimated amount of claims on customers that are expected to become uncollectible in the future.
- The credit balance in the allowance account will absorb the specific write-offs when they occur.
- Allowance for Doubtful Accounts is not closed at the end of the fiscal year.
- Bad Debts Expense is reported in the income statement as an operating expense (usually a selling expense).

Recording the Write-Off

- Each write-off should be approved in writing by authorized management personnel.
- Under the allowance method, every bad debt write-off is debited to the allowance account (not to Bad Debt Expense) and credited to the appropriate Account Receivable.
- A write-off affects only balance sheet accounts. Cash realizable value in the balance sheet, therefore, remains the same.

Recovery of an Uncollectible Account

- When a customer pays after the account has been written off, two entries are required:
  1. The entry made in writing off the account is reversed to reinstate the customer’s account.
  2. The collection is journalized in the usual manner.
- The recovery of a bad debt, like the write-off of a bad debt, affects only balance sheet accounts.
Work through the Hampson Furniture example. Assume Hampson Furniture has credit sales of $1,200,000 in 2012, of which $200,000 remains uncollected at December 31. The credit manager estimates that $12,000 of these sales will prove uncollectible. The adjusting entry to record the estimated uncollectibles is:

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Bad Debts Expense</td>
<td>12,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Allowance for Doubtful Accounts</td>
<td></td>
<td>12,000</td>
</tr>
<tr>
<td></td>
<td>(To record estimate of uncollectible accounts)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Bad Debts Expense is a selling expense. This entry has no effect on cash flows. The Allowance for Doubtful Accounts is a contra asset account and is shown on the balance sheet as a reduction from accounts receivable. Therefore Hampson’s balance sheet would report accounts receivable as follows:

Accounts receivable ........................................ $200,000
Less: Allowance for doubtful accounts ............... 12,000
$188,000

Assume that the vice-president of finance of Hampson Furniture on March 1, 2013, authorizes a write-off of a $500 balance owed by R. A. Ware. The entry to record the write-off is:

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar. 1</td>
<td>Allowance for Doubtful Accounts</td>
<td></td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable—R. A. Ware</td>
<td></td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>(Write-off of R. A. Ware account)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notice, the bad debt was written off to the allowance account not to the Bad Debts Expense account. Therefore, the write-off does not affect net income, nor does it affect net assets.

<table>
<thead>
<tr>
<th></th>
<th>Before Write-off</th>
<th>After Write-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$200,000</td>
<td>$199,500</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>12,000</td>
<td>11,500</td>
</tr>
<tr>
<td>Cash realizable value</td>
<td>$188,000</td>
<td>$188,000</td>
</tr>
</tbody>
</table>

When R. A. Ware pays Hampson the $500, two journal entries are required to record the collection:

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1</td>
<td>Accounts Receivable—R. A. Ware</td>
<td></td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>Allowance for Doubtful Accounts</td>
<td></td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>(To reverse write-off of R. A. Ware account)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>July 1</td>
<td>Cash</td>
<td></td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable—R A. Ware</td>
<td></td>
<td>500</td>
</tr>
</tbody>
</table>
Accounts Receivable and the Allowance for Doubtful Accounts both increase in entry (1) for two reasons: First the company made an error in judgment when it wrote off the account receivable. Second, R. A. Ware did pay, and therefore the Accounts Receivable account should show this collection for possible future credit purposes.

Ask students why the allowance method is required for financial statement reporting? Does the allowance method conform to the expense recognition principle? Does the allowance method follow GAAP? Why or why not?

In “real life,” companies must estimate the amount of expected uncollectible accounts if they use the allowance method.

Frequently the allowance is estimated as a percentage of the outstanding receivables.

- Management establishes a percentage relationship between the amount of receivables and expected losses from uncollectible accounts.
- Companies often prepare a schedule in which customer balances are classified by the length of time they have been unpaid.
- Because of its emphasis on time, this schedule is often called an aging schedule and the analysis of it is often called aging the accounts receivable.
- After the accounts are arranged by age, the expected bad debts losses are determined by applying percentages, based on past experience, to the totals of each category.
- The estimated bad debts represent the existing customer claims expected to become uncollectible in the future.
- This amount represents the required balance in Allowance for Doubtful Accounts at the balance sheet date.
- Accordingly, the amount of the bad debts expense adjusting entry is the difference between the required balance and the existing balance in the allowance account.

Occasionally the allowance account will have a debit balance prior to adjustment because write-offs during the year exceeded the beginning balance in the account.

- In such a case, the debit balance is added to the required balance when the adjusting entry is made.

Go over the “Ethics Insight” for this objective.

Discuss when it would be appropriate for a company to lower its allowance for doubtful accounts as a percentage of its receivables.

Study Objective 4 - Compute the Interest on Notes Receivable

- A promissory note is a written promise to pay a specified amount of money on demand or at a definite time.
  - In a promissory note, the party making the promise to pay is called the maker.
  - The party to whom payment is to be made is called the payee. The payee may be specifically identified by name or may be designated simply as the bearer of the note.
  - Notes receivable give the holder a stronger legal claim to assets than accounts receivable.
notes receivable, like accounts receivable, can be readily sold to another party. Promissory notes are negotiable instruments.

- are frequently accepted from customers who need to extend the payment of an outstanding account receivable, and they often require them from high-risk customers.

- There are three basic issues in accounting for notes receivable:
  1. **Recognizing** notes receivable.
  2. **Valuing** notes receivable.
  3. **Disposing** of notes receivable.

### Computing Interest

- The formula for computing interest is:
  
  Face Value of Note (principal) x Annual Interest Rate x Time (in terms of one year)

- The interest rate specified on the note is an annual rate of interest. The time factor in the computation expresses the fraction of a year that the note is outstanding.

- When the maturity date is stated in days, the time factor is frequently the number of days divided by 360. For example, the maturity date of a 60-day note dated July 17 is determined as follows:

<table>
<thead>
<tr>
<th>Term of note</th>
<th>60 days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days in July</td>
<td>31</td>
</tr>
<tr>
<td>Date of note</td>
<td>17</td>
</tr>
<tr>
<td>Note’s days in July</td>
<td>14</td>
</tr>
<tr>
<td>Days in August</td>
<td>31</td>
</tr>
<tr>
<td>Plus note’s days in July</td>
<td>14</td>
</tr>
<tr>
<td>Notes days to the end of August</td>
<td>45</td>
</tr>
<tr>
<td>Maturity date, September</td>
<td>15</td>
</tr>
</tbody>
</table>
When the due date is stated in terms of months, the time factor is the number of months divided by 12.

Some students may need help remembering how many days in each month. There is a little ditty, author unknown, which goes:

- 30 days hath September, April, June, and November.
- All the rest have 31, save February which has 28, except in leap year when it has 29.

You can also ask a student to demonstrate how they can use their knuckles to determine the months that have 31 days.

Go through the calculations of interest illustrated in the text:

<table>
<thead>
<tr>
<th>Terms of Note</th>
<th>Interest Computation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$730, 12%, 120 days</td>
<td>$730 \times 12% \times \frac{120}{360} = $29.20</td>
</tr>
<tr>
<td>$1,000, 9%, 6 months</td>
<td>$1,000 \times 9% \times \frac{6}{12} = $45.00</td>
</tr>
<tr>
<td>$2,000, 6%, 1 year</td>
<td>$2,000 \times 6% \times \frac{1}{1} = $120.00</td>
</tr>
</tbody>
</table>

Although most financial institutions use 365 days in computing interest, problems in the text assume 360 days.

Recognizing Notes Receivable

- To illustrate the basic entry for notes receivable, the text uses Brent Company’s $1,000, two-month, 8% promissory note dated May 1. Assume that the note was written to settle an open account. The entry for the receipt of the note by Wilma Company is as follows:

  May 1
  Notes Receivable ................................................. 1,000
  Accounts Receivable—Brent Company........ 1,000
  (To record acceptance of Brent Company note)

- The note receivable is recorded at its face value, the value shown on the face of the note.

- No interest revenue is reported when the note is accepted because the revenue recognition principle does not recognize revenue until earned. Interest is earned (accrued) as time passes.

- If a note is exchanged for cash, the entry is a debit to Notes Receivable and a credit to Cash in the amount of the note.
Valuing Notes Receivable

- Like accounts receivable, short-term notes receivable are reported at their cash (net) realizable value.
- The notes receivable allowance account is Allowance for Doubtful Accounts.
- The computations and estimations involved in determining bad debts expense are similar to the ones related to accounts receivable.

Study Objective 5 - Describe the Entries to Record the Disposition of Notes Receivable

- Notes may be held to their maturity date, at which time the face value plus accrued interest is due.
- In some situations, the maker of the note defaults, and an appropriate adjustment must be made by the payee.
- A note is **honored** when it is paid in full at maturity.

---

**TEACHING TIP**

Work through the illustration in the text which assumes that Wolder Co. lends Higley, Inc. $10,000 on June 1, accepting a 5-month, 9% interest note. If Wolder presents the note to Higley Inc. on November 1, the maturity date, the entry by Wolder to record the collection is:

Nov. 1  
Cash.............................................................................. 10,375  
Notes Receivable .................................................. 10,000  
Interest Revenue ............................................... 375*  
(To record collection of Higley Inc. note and interest)

*$10,000 x 9% x 5/12 = $375

If Wolder prepares financial statements as of September 30, the following adjusting entry would be made to accrue interest revenue.

Sept. 30  
Interest Receivable.................................................. 300  
Interest Revenue ............................................... 300  
(To accrue 4 months’ interest on Higley note)

When interest has been accrued, the entry to record the honoring of Higley’s note on November 1 is:

Nov. 1  
Cash.............................................................................. 10,375  
Notes Receivable .................................................. 10,000  
Interest Receivable.................................................. 300  
Interest Revenue ............................................... 75*  
(To record collection of Higley Inc. note and interest)

*$10,000 x 9% x 1/12 = $75

- A **dishonored note** is a note that is not paid in full at maturity.
If the lender expects that it will eventually be able to collect, the Notes Receivable account is transferred to an Account Receivable for both the face value of the note and the interest due.

If there is no hope of collection, the face value of the note should be written off.

**Study Objective 6 - Explain the Statement Presentation of Receivables**

- Each of the major types of receivables should be identified in the balance sheet or in the notes to the financial statements.
- Short-term receivables are reported in the current assets section of the balance sheet below short-term investments. These assets are nearer to cash and are thus more liquid.
- Both the gross amount of receivables and the allowance for doubtful accounts should be reported.
- Bad debts expense is reported under “Selling expenses” in the operating expenses section of the income statement.
- Interest revenue is shown under “Other revenues and gains” in the nonoperating section of the income statement.
- If a company has significant risk of uncollectible accounts or other problems with receivables, it is required to discuss this possibility in the notes to the financial statements.

**TEACHING TIP**

Students need to understand the advantage of having a note receivable rather than an account receivable. Notes earn interest and give the holder a stronger legal claim to assets than accounts receivable. In addition, a note receivable may be a negotiable instrument and may be transferred to another party by endorsement.

**Study Objective 7 - Describe the Principles of Sound Accounts Receivable Management**

- Managing accounts receivable involves five steps:
  1. Determine to whom to extend credit.
  2. Establish a payment period.
  4. Evaluate the liquidity of receivables.
  5. Accelerate cash receipts from receivables when necessary.
♦ Determine to whom to extend credit.
1. Risky customers might be required to provide letters of credit or bank guarantees.
2. Particularly risky customers might be required to pay cash on delivery.
3. Ask potential customers for references from banks and suppliers and check the references.
4. Periodically check the financial health of continuing customers (Dun and Bradstreet).

♦ Establish a payment period.
1. Determine a required payment period and communicate that policy to customers.
2. Make sure company’s payment period is consistent with that of competitors.

♦ Monitor collections.
1. Prepare accounts receivable aging schedule at least monthly.
2. Pursue problem accounts with phone calls, letters, and legal action if necessary.
3. Make special arrangements for problem accounts.

Stress the importance of having competent personnel working in the credit department and the collections department. Discuss this as a control to prevent fraud. Ask students to list effective credit policies.

4. If a company has significant concentrations of credit risk, it must discuss this risk in the notes to its financial statements.

5. A **concentration of credit risk** is a threat of nonpayment from a single large customer or class of customers that could adversely affect the financial health of the company.

**Study Objective 8 - Identify Ratios to Analyze a Company’s Receivables**

♦ Liquidity is measured by how quickly certain assets can be converted into cash. The ratio used to assess the liquidity of the receivables is the **receivables turnover ratio**.

♦ The ratio measures the number of times, on average, receivables are collected during the period.

♦ The receivables turnover ratio is computed by dividing net credit sales (net sales less cash sales) by the average net accounts receivables during the year.

♦ A popular variant of the receivables turnover ratio is to convert it into an **average collection period** in terms of days. This is computed by dividing the receivables turnover ratio into 365 days.

♦ The general rule is that the average collection period should not greatly exceed the credit term period (i.e., the time allowed for payment). However if customers pay slowly, the retailer earns a healthy return on the outstanding receivables in the form of high interest rates.

In some cases, receivables turnover may be misleading. Therefore, it is important to know how a company manages its receivables.

**Study Objective 9 - Describe Methods to Accelerate the Receipt of Cash from Receivables**

♦ Two common expressions apply to the **collection** of receivables:
1. “Time is money”—that is, waiting for the normal collection process costs money.
2. “A bird in the hand is worth two in the bush”—that is, getting the cash now is better than getting it later or not at all.

♦ There are three reasons for the sale of receivables.
1. The size of the receivables may cause a company to sell them because it may not want to hold such a large amount of receivables. In recent years, for competitive reasons, sellers (retailers, wholesalers, and manufacturers) often have provided financing to purchasers of their goods. The purpose is to encourage the sale of the company’s product by assuring financing to buyers.
2. Receivables may be sold because they may be the only reasonable source of cash. When credit is tight, companies may not be able to borrow money in the usual credit markets or the cost of borrowing may be prohibitive.
3. A final reason for selling receivables is that billing and collection are often time-consuming and costly. As a result, it is often easier for a retailer to sell the receivables to another party that has expertise in billing and collection matters.

National credit card sales:
♦ Approximately one billion credit cards are recently in use. A common type of credit card is a national credit card such as Visa and MasterCard.

♦ Three parties are involved when national credit cards are used in making retail sales: (1) the credit card issuer, who is independent of the retailer, (2) the retailer, and (3) the customer.

♦ A retailer’s acceptance of a national credit card is another form of selling—factoring—the receivable by the retailer.

♦ There are several advantages of credit cards for the retailer:
1. Issuer does credit investigation of customer.
2. Issuer maintains customer accounts.
3. Issuer undertakes collection process and absorbs any losses.
4. Retailer receives cash more quickly from credit card issuer.
   - In exchange for these advantages, the retailer pays the credit card issuer a fee of 2% to 4% of the invoice price for its services.

♦ Sales resulting from the use of national credit cards are considered cash sales by the retailer. Upon receipt of credit card sales slips from a retailer, the bank that issued the card immediately adds the amount to the seller’s bank balance.
To illustrate, Morgan Marie purchases $1,000 of compact discs for her restaurant from Sondgeroth Music Co., and she charges this amount on her Visa First Bank Card. The service fee that First Bank charges Sondgeroth Music is 3%. The entry by Sondgeroth Music to record this transaction is:

\[
\begin{align*}
\text{Cash} & \quad 970 \\
\text{Service Charge Expense} & \quad 30 \\
\text{Sales} & \quad 1,000 \\
\end{align*}
\]

(To record Visa credit card sales)

**TEACHING TIP**

Ask students if it is a good idea to issue credit? If you had a small business would you issue credit directly to customers or would you accept VISA, MasterCard, Discover and/or American Express.

How do VISA, MasterCard, and American Express make money? Why do some businesses accept VISA and MasterCard but not accept American Express or Discover?

Sale of receivables to a factor:

- A common way to accelerate receivables collection is a sale to a factor. A factor is a finance company or bank that buys receivables from businesses for a fee and then collects the payments directly from the customers.

- Factoring arrangements vary widely, but typically the factor charges a commission of 1% to 3% of the amount of receivables purchased.

**TEACHING TIP**

Go through the example on factoring in the book, assuming Hendredon Furniture factors $600,000 of receivables to Federal Factors, Inc. Federal Factors assesses a service charge of 2% of the amount of receivables sold. Hendredon makes the following journal entry:

\[
\begin{align*}
\text{Cash} & \quad 588,000 \\
\text{Service Charge Expense} & \quad 12,000^* \\
\text{Accounts Receivable} & \quad 600,000 \\
\end{align*}
\]

(To record the sale of accounts receivable)

*$600,000 \times 2\% = $12,000

The service charge expense is recorded as a selling expense, if the company usually sells its receivables on a regular basis.

If the company sells receivables infrequently, it may report this amount under “Other expenses and losses” in the income statement.