Accounting 2303 Week 8

Chapter 5 Part 1- Direct Write-Offs and the Allowance Method for Doubtful Accounts

Hello everyone! This week the resource will be walking through ways to account for uncollectable accounts. Additionally, I will be providing Accounting group tutoring sessions from 6:30-7:30pm on Tuesdays over Microsoft Teams each week. If you would like to attend those sessions or want to schedule a 1-on-1 appointment with one of our fantastic accounting tutors, please visit www.baylor.edu/tutoring to make an appointment!

-Jerry

What happens when we cannot collect our accounts receivable?

The accounts receivable account represents a promise made by an external company to pay for goods or services at a later date. Sometimes companies will not be able to pay these debts that they owe. As such, will need to adjust our records to reflect the delinquency of these accounts. To do this, we use either the **Direct Write-Off method** or the **Allowance method.**

What is the Direct Write-Off Method?

The direct write-off method waits until an account is determined to be uncollectable before it "write's off" the account. To "write off" an account under this method we use the following journal entry:

DR: Bad Debt Expense (for the amount uncollectible).

CR: Accounts Receivable (for the amount uncollectible).

This journal entry gets rid of the expectation that we will receive these funds and records this amount as an expense.

What are the shortcomings of the Direct Write-Off Method?

This method violates the expense matching principle by not recognizing an expense in the same period that revenue is earned. In doing so, this method violates GAAP and overstates assets and net income. This method will only be used in tax reporting.

What is the Allowance Method?

The allowance method is a two step process that estimates bad debt expense at the end of the current accounting period and uses adjusting entries to write off customer accounts that become uncollectable. To do this, we use the following journal entries:

Estimate Journal Entry:

DR: Bad Debt Expense

CR: Allowance for Doubtful Accounts

Write-Off Entry:

DR: Allowance for Doubtful Accounts

CR: Accounts Receivable

Note that the allowance method is required by GAAP and introduces a new account: Allowance for Doubtful Accounts

What is the Allowance for Doubtful Accounts?

This account reflects the amount of accounts receivable that we do not expect to collect. It is a **contra-asset** meaning that this account is listed as an account on the balance sheet that reduces an asset. The allowance for doubtful accounts account specifically reduces the accounts receivable account and yields a helpful equation for determining how much of accounts receivable a company expects to the collect. This amount is called the Net Realizable Value.

NRV= Accounts Receivable-AFDA

Methods Used to Estimate Bad Debt Expense and Allowance for Doubtful Accounts

The **percent of sales method** uses a predetermined percentage of sales to estimate BDE and AFDA. This is also called the income statement approach.

(Source: Pearson Education 2015)

The following example gives a good example of this method in action:

https://www.youtube.com/watch?v=ZjkbN4ofu10&feature=youtu.be

The **Aging of Receivables Method** assigns a percentage estimate based on the age (how long the customer AR account has been outstanding) of the accounts receivable. This is illustrated in the following graphic.

Age of Account (Dollar amounts rounded to the nearest million)					
Customer	1–30 Days	31–60 Days	61–90 Days	Over 90 Days	Total Balance
Best Buy					
Walmart					
Totals	$14,943	$ 600	$ 200	$ 64	$15,807
Estimated percent uncollectible	× 0.2075%	× 1%	× 5%	× 10%	
Allowance for Uncollectible Accounts balance should be	$ 31* +	$ 6 +	$ 10 +	$ 6* =	$ 53

(Source: Pearson Education)

The following video gives a good example of this method in action:

https://www.youtube.com/watch?v=1wq1rw46NTc&feature=youtu.be

Examples:

Direct Write-Off:

Bob the Tomato received notice that Larry the Cucumber would not be able to pay what he owed to Bob (totaling: $5,000,000). What would the JE be under the Direct method?

A: DR: Bad Debt Expense: $5,000,000

CR: Allowance for Doubtful Accounts: $5,000,000

Allowance Method:

Texas INC uses the Percentage of sales method to adjust the allowance for uncollectible accounts at the end of the period. At December 31, 2020, the balance of accounts receivable is $220,000 and the allowance for uncollectible accounts has a credit balance of $3,200 (before adjustment). Total sales for the year are $800,000 of which $200,000 are cash sales. If Texas estimates bad debts to be 2% of credit sales, bad debt expense would be?

A: $12,000 (($800,000-$200,000)*.02)

What would the balance of the AFDA account be after the adjustment for Bad Debt Expense?

A: $15,200 (3200+12000)

Sources:

Edspira.com

Financial Accounting by Harrison, Horngren, and Thomas, 12th Edition, Prentice Hall via Pearson Education 2015