Valuing our Accounts Receivable

Dealing with Bad Debts Expense (aka “Doubtful Accounts”)

Understanding the Allowance Methods
At the end of each period, we estimate the total bad debts expected to be incurred from that period's activities.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>PR</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>Bad Debts Expense</td>
<td>90</td>
<td>2,000.00</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>Allowance for Doubtful Accounts</td>
<td>90</td>
<td>2,000.00</td>
<td></td>
</tr>
</tbody>
</table>

How we go about calculating Bad Debts figure is what creates the two different approaches. If we calculate the Bad Debts figure as:
Percent of Sales → Income Statement Method
Percent of Accounts Receivable → Balance Sheet Method

Percent of Sales Example
Microcosm Inc. has sales of $200,000 and estimates 1.0% of those sales will not be collectible. Estimated Bad Debts Expense is calculated as $2,000.

$200,000.00  
X 1.0%  
= $2,000.00

Percent of Sales (Income Statement Method)
Under the percent of sales method, bad debts expense is computed as follows:

Current Period Sales  
×  Estimated Bad Debt %  
= Estimated Bad Debts Expense

Percent of Accounts Receivable (Balance Sheet Method)
Using the percent of accounts receivable approach, we focus on estimating the Allowance for Doubtful Accounts as:

Month-end Accounts Receivable × Bad Debt %  
= Estimated Bad Debts Expense

Estimated adjusted balance in Allowance for Doubtful Accounts
= Unadjusted period-end balance in Allowance for Doubtful Accounts
= Estimated Bad Debts Expense
Doubtful Accounts

Our aim is to create a desired balance in Allowance for Doubtful Accounts.

\[
\begin{align*}
\text{\$50,000} & \times \text{5.00}\% \\
\text{= \$2,500}
\end{align*}
\]

Reviewing Methods to Estimate Bad Debts

- % of Sales
- Emphasis on Matching
- % of Receivables
- Emphasis on Realizable Value

Allowance for Doubtful Accounts


Writing Off a Bad Debt

- Within either allowance method, when an account is determined to be uncollectible, Allowance for Doubtful Accounts will be debited...
- and the customer’s account receivable will be credited.

Direct Write-Off Method Example

- On January 23, TechCom determines it cannot collect $520 from Jack Kent, a credit customer.
- The account is expensed at time of write-off.

Recovery of a Bad Debt

- Subsequent collections require that the original write-off entry be reversed before the cash collection is recorded.

Direct Write-Off Method

- If Jack Kent later pays the $520, the previous entry is simply reversed and the cash collection is recorded.

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 23 Allowance for Doubtful Accounts</td>
<td>520</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable - Kent</td>
<td></td>
<td>520</td>
</tr>
<tr>
<td>To record write-off of Jack Kent's uncollectible account</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar. 11 Accounts Receivable - Kent</td>
<td>520</td>
<td></td>
</tr>
<tr>
<td>Bad Debt Expense</td>
<td></td>
<td>520</td>
</tr>
<tr>
<td>To record receipt of payment</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Aging of Accounts Receivable Method

1. Year-end Accounts Receivable is broken down into age classifications.
2. Each age grouping has a different likelihood of being uncollectible.
3. Compute a separate allowance for each age grouping.

Aging of Accounts Receivable Example

At December 31, 2001, the receivables for DeCor were categorized as follows:

<table>
<thead>
<tr>
<th>Days Past Due</th>
<th>Accounts Receivable Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$37,000</td>
</tr>
<tr>
<td>1 - 30</td>
<td>6,500</td>
</tr>
<tr>
<td>31 - 60</td>
<td>3,500</td>
</tr>
<tr>
<td>61 - 90</td>
<td>1,900</td>
</tr>
<tr>
<td>Over 90</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$49,900</strong></td>
</tr>
</tbody>
</table>

Using estimated bad debt percentages, DeCor would calculate the estimated uncollectible amount as follows:

- Current: $37,000 * 2% = $740
- 1 - 30: 6,500 * 5% = $325
- 31 - 60: 3,500 * 10% = $350
- 61 - 90: 1,900 * 25% = $475
- Over 90: 1,000 * 40% = $400

**Total Estimated Uncollectible Amount:** $2,290

DeCor’s unadjusted balance in the allowance account is a debit of $200.

The previous computation shows the desired balance is $2,290. Therefore, the adjusting entry is for $2,290 + 200 = $2,490.

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</thead>
<tbody>
<tr>
<td>2004</td>
<td>Bad Debts Expense</td>
<td>200</td>
<td>2,490.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Allowance for Doubtful Accounts</td>
<td>200</td>
<td>2,490.00</td>
<td>2,490.00</td>
</tr>
</tbody>
</table>

To record estimate of bad debt expense.