Accounts Receivable

Planning and Recording an Allowance for Uncollectible Accounts Adjustment

With each sale on account, a business takes a risk that customers will not pay their accounts. Accounts receivable that cannot be collected are called **uncollectible accounts**. This risk is a cost of doing business that should be recorded as an expense in the same accounting period that the revenue is earned.

At the end of a fiscal year, a business does not know which customer accounts will become collectible. If a business knew exactly which accounts would become uncollectible, it could credit accounts receivable and each customer account for the uncollectible accounts and debit uncollectible accounts expense for the same amount. But there’s no way to know for sure.

To solve this accounting problem, a business can calculate and record an estimated amount of uncollectible accounts expense. Estimating uncollectible accounts expense at the end of the fiscal period accomplishes two objectives:

1. It reports a balance sheet amount of accounts receivable that reflects the amount the business expects to collect in the future.
2. It recognizes the expense of uncollectible accounts in the same period in which the related revenue is recorded.

To record estimated uncollectible accounts, an adjusting entry is made affecting two accounts. The estimated amount of uncollectible accounts is debited to “Uncollectible Accounts Expense” and credited to an account called “Allowance for Uncollectible Accounts”. You’ll recall that an account that reduces a related account is called a contra account. Allowance for Uncollectible Accounts is a contra account to its related account, Accounts Receivable.

Crediting the estimated value of uncollectible accounts to a contra account is called **the allowance method of recording losses from uncollectible accounts**. The difference between an asset’s account balance and its related contra account balance is called **book value**. The difference between the balance of accounts receivable and allowance for uncollectible accounts is called **book value of accounts receivable**. The book value of accounts receivable, which is reported on the balance sheet, represents the total amount of accounts receivable the business expects to collect in the future.

Many businesses use a percentage of total sales on account to estimate uncollectible accounts expense. Each sale on account represents a risk of loss from an uncollectible account. Therefore, if the estimated percentage of loss is accurate, the amount of uncollectible accounts expense will be accurate regardless of when the actual losses occur.

Example

Hobby Shack estimates uncollectible accounts expense by calculating a percentage of total sales on account. A review of Hobby Shack’s previous experience in collecting sales on account shows that actual uncollectible accounts expense has been about 1% of total sales on account. The company’s total sales on account for the year is $124,500.00. Thus, Hobby Shack estimates that $1,245.00 of the current fiscal year’s sales on account will eventually be uncollectible.

TRIAL BALANCE

ACCOUNT TITLE	UNADJUSTED		Adjustments		ADJUSTED	
	Debit	Credit	Debit	Credit	Debit	Credit
Accounts Receivable	14,698.40				14,698.40	
Allowance for Uncollectible Accounts		127.52		1,245.00		1,372.52
Uncollectible Accounts Expense			1,245.00		1,245.00	

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2016 Date		Account Title	Doc. No.	Post. Ref.	Debit	Credit
December	*31*	*Uncollectible Accounts Expense*			1,245.00	
		Allowance for Uncollectible Accounts				1,245.00

Practice Problem 1: Coastal Aquatics

Coastal Aquatics estimates uncollectible accounts expense as 0.5% of its total sales on account. During April 2018, Coastal Aquatics had sales on account of $424,000.00. Prepare the adjusting entry in the trial balance and journalize the transaction in the general journal.

TRIAL BALANCE

ACCOUNT TITLE	UNADJUSTED		Adjustments		ADJUSTED	
	Debit	Credit	Debit	Credit	Debit	Credit
Accounts Receivable	18,200.00					
Allowance for Uncollectible Accounts		240.00				
Uncollectible Accounts Expense						

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2018 Date		Account Title	Doc. No.	Post. Ref.	Debit	Credit
April	*30*					

Practice Problem 2: Sonoma Treasures

Sonoma Treasures estimates uncollectible accounts expense as 0.4% of its total sales on account. During March 2018, Sonoma Treasures had sales on account of $462,500.00. Prepare the adjusting entry in the trial balance and journalize the transaction in the general journal.

TRIAL BALANCE

ACCOUNT TITLE	UNADJUSTED		Adjustments		ADJUSTED	
	Debit	Credit	Debit	Credit	Debit	Credit
Accounts Receivable	22,500.00					
Allowance for Uncollectible Accounts		560.00				
Uncollectible Accounts Expense						

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2018 Date		Account Title	Doc. No.	Post. Ref.	Debit	Credit
March	*31*					