Case Study: Uncollectible Accounts

by Sophia

	WHAT'S COVERED

This tutorial will cover a case study focusing on calculating uncollectible accounts for a hypothetical subject company.

Our discussion breaks down as follows:

1. Case Study: Legacy Clothing

The subject company for our case study is called Legacy Clothing. Legacy Clothing is a sole proprietorship, which is a type of company that is owned by a single individual, and where that individual and the business are legally treated as the same.

The purpose of Legacy Clothing as a business is to own and operate clothing/merchandise stores. It is similar to a department store chain, selling men's, women's, and children's clothing and other related items.

Legacy Clothing has locations throughout Washington, DC, and they have a staff of 50 people employed in their stores.

Legacy Clothing	
Type of company	Sole proprietorship
Business purpose	Own and operate clothing/merchandise stores
Business location(s)	Washington, D.C. Staff of 50 people

Legacy Clothing needs to estimate uncollectible accounts because they need to recognize the amounts expected not to be collected from credit customers. In other words, if there are any customers that Legacy Clothing has sold merchandise to on credit, or on account, that they do not expect to collect payment for those goods, they need to recognize the amounts of those transactions.

It is important to do this because they need to have accurate reporting, which is a requirement for their financial reporting.

Also, it is necessary for matching; they need to be able to match this bad debt expense with the credit sales, to record the expected loss from their credit sales. In addition, they need to match the expense with the

period that the event or the transaction occurred.

There are several common methods that we can use to estimate our uncollectible accounts:

- Percentage of net credit sales: Balance in the allowance account is NOT considered.
- Percentage of receivables: Balance in the allowance account is considered.
- Aging receivables: Balance in the allowance account is considered.

Now that we've established that Legacy Clothing does indeed need to estimate uncollectible accounts, let's walk through examples of estimating those accounts using each of the three methods mentioned above.

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2. Case Study: Percentage of Net Credit Sales

The first calculation we're going to look at is percentage of net credit sales.

The information we need is total net credit sales and our estimated percent uncollectible, so that we can perform our calculation to determine our allowance, which is net credit sales multiplied by percent uncollectible.

Legacy Clothing				
Percentage of Net Credit Sales				
Total Net Credit Sales				
Estimated % uncollectible				
		Net Credit Sales		
	X	% uncollectible		
		Allowance		

For the purposes of this exercise, Legacy Clothing has total net credit sales of $500,000. We estimate the percent uncollectible is 3%. So, if we take our net credit sales and multiply by our percent uncollectible, we calculate our allowance to be $15,000.

Legacy Clothing				
Percentage of Net Credit Sales				
Total Net Credit Sales	$	500,000		
Estimated % uncollectible		3%		
	$	500,000		
	X	3%		
	$	15,000		

We need to record a journal entry. We're going to debit "Bad Debt Expense" for $15,000 and credit "Allowance for Uncollectible Accounts" for $15,000, because again, using this method, we don't need to consider the balance that is already in the allowance account.

Legacy Clothing				
Percentage of Net Credit Sales				
Total Net Credit Sales	$	500,000		
Estimated % uncollectible		3%		
	$	500,000		
X		3%		
	$	15,000		
Journal Entry:				
Bad Debt Expense			$15,000	
Allowance for Uncollectible Accounts				$15,000

3. Percentage of Receivables

Now we're going to look at estimating our allowance using the percentage of receivables.

We take our total accounts receivables and we multiply it by our total estimated percent uncollectible to determine our allowance.

Legacy Clothing			
Percentage of Receivables			
Total Receivables			
Estimated % uncollectible			
	Accounts Receivable		
X	**% uncollectible**		
	Allowance		

In this case, Legacy Clothing has $200,000 in receivables and an estimated percent uncollectible of 3%. Therefore, if we input this information into our formula, we determine that our allowance should be $6,000.

Legacy Clothing					
Percentage of Receivables					
	Total Receivables	$	200,000		
	Estimated % uncollectible		3%		
		$	200,000		
	X		3%		
		$	6,000		

Now, let's look at a couple scenarios involving different balance amounts in our allowance account. Remember, under percentage of receivables, we have to consider the balance in that allowance account.

↗ EXAMPLE **Scenario 1**: In the first scenario, there's no balance in our allowance account.

For our journal entry, it's going to be a debit to "Bad Debt Expense" and a credit to "Allowance for Uncollectible Accounts" of $6,000, which is the amount calculated above.

Scenario 1:	No balance in 'Allowance for Uncollectible Accounts'		
Journal Entry:			
	Bad Debt Expense	$6,000	
	Allowance for Uncollectible Accounts		$6,000

↗ EXAMPLE **Scenario 2**: In the second scenario, let's assume that there is a $2,000 balance already in our "Allowance for Uncollectible Accounts."

For our journal entry, it's still going to be a debit to "Bad Debt Expense" and a credit to "Allowance for Uncollectible Accounts."

However, you can see that it's only for $4,000, because the total balance needs to be $6,000. We already have $2,000 in there, so we only need to increase that allowance account by $4,000.

Scenario 2:	$2,000 balance in 'Allowance for Uncollectible Accounts'		
Journal Entry:			
	Bad Debt Expense	$4,000	
	Allowance for Uncollectible Accounts		$4,000

4. Aging Receivables

The last method we're going to use to estimate our uncollectible accounts is aging receivables.

Here is an aging schedule of all of our receivables from all of our customers. It categorizes all receivables based on the days outstanding.

Legacy Clothing
Aging Receivables

Customer	1-30 days	31-60 days	Balance 61-90 days	91-180 days	181+ days	Total Balance 12/31/12
Customer A	$25,000	$15,000	$5,000			$45,000
Customer B	$10,000	$13,000				$23,000
Customer C	$5,000		$3,000	$10,000		$18,000
Customer D	$1,000		$3,000		$7,500	$11,500
Customer E	$2,500	$10,000	$5,000	$5,000		$22,500
Customer F	$20,000				$10,000	$30,000
Customer G	$30,000			$5,000	$15,000	$50,000
Total	**$93,500**	**$38,000**	**$16,000**	**$20,000**	**$32,500**	**$200,000**
Uncollectible (%)	2%	10%	25%	45%	85%	

Now, we need to take this aging schedule and apply these uncollectible percentages that we've estimated. Remember, these percentages grow as the days outstanding of that receivable increase.

So, we take the total balance of receivables that fall into a specific day category, and multiply that by the corresponding uncollectible percentage to calculate the total uncollectible amount in dollars for each time period.

Note, our total uncollectible balance is $46,295, which is our allowance.

Legacy Clothing
Aging Receivables

Customer	1-30 days	31-60 days	Balance 61-90 days	91-180 days	181+ days	Total Balance 12/31/12
Customer A	$25,000	$15,000	$5,000			$45,000
Customer B	$10,000	$13,000				$23,000
Customer C	$5,000		$3,000	$10,000		$18,000
Customer D	$1,000		$3,000		$7,500	$11,500
Customer E	$2,500	$10,000	$5,000	$5,000		$22,500
Customer F	$20,000				$10,000	$30,000
Customer G	$30,000			$5,000	$15,000	$50,000
Total	**$93,500**	**$38,000**	**$16,000**	**$20,000**	**$32,500**	**$200,000**
	x					
Uncollectible (%)	2%	10%	25%	45%	85%	
						Total Uncollectible Balance
	=					
Uncollectible ($)	$1,870	$3,800	$4,000	$9,000	$27,625	→ $46,295

Once again, using this total allowance, let's look at a couple scenarios involving different balance amounts in our "Allowance for Uncollectible Accounts."

↗ EXAMPLE **Scenario 1**: For Scenario 1, let's assume there is no balance in our "Allowance for Uncollectible Accounts."

For our journal entry, we're going to have a debit to "Bad Debt Expense" and a credit to "Allowance for Uncollectible Accounts" for the full amount of $46,295.

						Total Uncollectible Balance
Uncollectible ($)	$1,870	$3,800	$4,000	$9,000	$27,625	**$46,295**
Scenario 1: Assume there is no balance in 'Allowance for Uncollectible Accounts'						
Journal Entry:	Bad Debt Expense			$46,295		
	Allowance for Uncollectible Accounts				$46,295	

↗ EXAMPLE **Scenario 2**: In the second scenario, let's assume there is already a $6,000 balance in our "Allowance for Uncollectible Accounts."

For our journal entry, it's still a debit to "Bad Debt Expense" and a credit to "Allowance for Uncollectible Accounts," but only in the amount of $40,295. Because there is already $6,000 in that allowance account, we only need to increase it by the difference in order to get to that total balance of $46,295.

						Total Uncollectible Balance
Uncollectible ($)	$1,870	$3,800	$4,000	$9,000	$27,625	**$46,295**
Scenario 1: Assume there is no balance in 'Allowance for Uncollectible Accounts'						
Journal Entry:	Bad Debt Expense			$46,295		
	Allowance for Uncollectible Accounts				$46,295	
Scenario 2: Assume there is a $6,000 balance in 'Allowance for Uncollectible Accounts'						
Journal Entry:	Bad Debt Expense			$40,295		
	Allowance for Uncollectible Accounts				$40,295	

☑ SUMMARY

Today we introduced our **case study** company called **Legacy Clothing**, a department store selling men's, women's, and children's clothing and other related items. We walked through examples of estimating **uncollectible accounts** using **percentage of net credit sales**, **percentage of receivables**, and **aging receivables**.

Source: Adapted from Sophia instructor Evan McLaughlin.