Uncollectible Accounts

by Sophia

WHAT'S COVERED

This tutorial will cover the topic of uncollectible accounts.

Our discussion breaks down as follows:

1. Uncollectible Accounts

Uncollectible accounts are are accounts receivable that are unpaid and are written off as "Bad Debts Expense".

Now, when a business sells goods and services on account, it's inevitable that some customers will not pay. However, we still need to recognize and record these uncollectible accounts.

We need to recognize the amounts expected *not* to be collected from credit customers. Any amounts that we don't expect to collect from customers who made a purchase on account--meaning those who we extended credit to as a business--need to be recorded in our financial statements.

TERM TO KNOW

Uncollectible Account
Accounts receivable that are unpaid and are written off as Bad Debts Expense.

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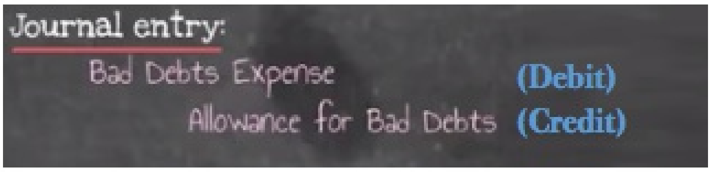
2. Allowance Method

Now, there are two methods that are used to record uncollectible accounts. The first method we will discuss is the allowance method.

The allowance method is required for financial reporting, so this is the *required* method. The allowance method allows us to match our bad debts expense with the period in which the event occurred. Put another way, it allows us to match that expense with the revenue transaction that took place, that is the source of the bad debts we are recording.

Now, there is an adjustment, or adjusting entry, that needs to be made at the end of the period. Remember, we make our adjustments for our allowance at the end of the period. The journal entries for this adjustment are a debit to bad debts expense and a credit to allowance for bad debts, or allowance for uncollectible accounts.



The key here is that an allowance account is going to be credited. This allowance account is a contra asset account, meaning it reduces the accounts receivable. It's recorded separately from accounts receivable so that we can maintain and track our accounts receivable, and then we track our allowance separately.

To determine uncollectible accounts, a business or a company creates their own estimate of the amount deemed to be uncollectible. They can use information about industry standards, the past experience they've had with uncollectible accounts, and any other logical estimations that management can determine.

Some common methods used to calculate the uncollectible accounts are:

- Percentage of net credit sales
- Aging receivables
- Percentage of receivables

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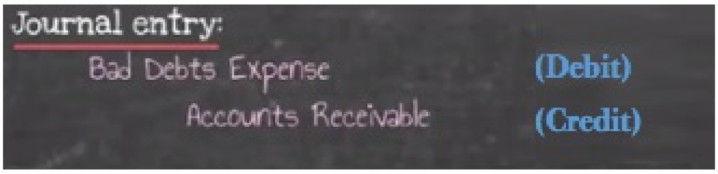
3. Direct Write-Off Method

The second method used to record uncollectible accounts is the direct write-off method.

Generally, the direct write-off method is not used in practice. If you recall, the allowance method is required for financial reporting.

However, if we were to use the direct write-off method, we would still make an adjusting entry at the end of the period. This entry will be slightly different than the entry under the allowance method. Again, we would debit bad debts expense, but this time, our credit would be directly to accounts receivable. We're still reducing accounts receivable, but it's a *direct* reduction of our accounts receivable.



Under the direct write-off method, we're removing our accounts receivable. However, this can create errors or additional work if accounts that we had written off are later collected. It also reduces the ability of a business to track outstanding accounts and follow up for collection.

Now, determining uncollectible accounts within the direct write-off method is very similar to the allowance method. A company or business creates their own estimates, using industry standards, past experience, and any other logical explanations.

Note, too, that within the direct write-off method, there might be a review of specific accounts for specific accounts that get written off.

SUMMARY

Today we learned all about **uncollectible accounts**, which are accounts receivable that are unpaid and are written off as bad debts expense. We explore the two methods of recording uncollectible accounts: the **allowance method**, which is the required method for financial reporting; and the**direct write-off method**, which is not used in practice.

Source: Adapted from Sophia instructor Evan McLaughlin.

TERMS TO KNOW

Uncollectible account
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