

## 2.3: The Problem with Estimations

### Learning Objectives

At the end of this section, students should be able to meet the following objectives:

1. Record the impact of discovering that a specific receivable is uncollectible.
2. Understand the reason that an expense is not recognized when a specific receivable is deemed to be uncollectible.
3. Recognize that estimated figures often prove to be erroneous but changes in previous year figures are not made if a reasonable estimate was made.

*Question: The company in the illustration in the last section expects to collect an amount from its receivables that will not materially differ from \$93,000. The related \$7,000 expense is recorded in the same period as the revenue through an adjusting entry. What happens when an actual account is determined to be uncollectible? For example, assume that on March 13, Year Two, a \$1,000 balance proves to be worthless. The customer dies, declares bankruptcy, disappears, or just refuses to make payment. This is not a new expense; \$7,000 was already anticipated and recognized in Year One. It is merely the first discovery. How does the subsequent write-off of a receivable as being uncollectible affect the various T-account balances?*

*Answer:* When an account proves to be uncollectible, the receivable T-account is decreased. The \$1,000 balance is simply removed. It is no longer viewed as an asset because it does not have future economic benefit. Furthermore, the anticipated amount of bad accounts is no longer \$7,000. Because this first worthless receivable has been identified and eliminated, only \$6,000 remains in the allowance.

The following journal entry is made to **write off** this account. This entry is repeated whenever a balance is found to be worthless. No additional expense is recognized. The expense was estimated and recorded in the previous period based on applying accrual accounting and the matching principle.

Figure 2.4 Journal Entry during Year Two—Write-Off of Specific Account as Uncollectible

Allowance for Doubtful Accounts	1,000		(decrease a contra asset—debit)
Accounts Receivable		1,000	(decrease an asset—credit)

**Note that both of these accounts are in the asset section and both are decreased. A decrease in a contra asset increases assets so that this entry does not change total assets or any other section of the accounting equation.**

The two basic steps in the recording of doubtful accounts are:

1. The amount of bad accounts is estimated whenever financial statements are to be produced. An adjusting entry then recognizes the expense in the same period as the sales revenue. It also increases the allowance for doubtful accounts (to reduce the reported receivable balance to its anticipated net realizable value).
2. Subsequently, whenever a specific account is deemed to be worthless, the balance is removed from both the accounts receivable and the allowance for doubtful accounts T-accounts. The related expense has been recognized previously and is not affected by the removal of the uncollectible account. With no change to the expense there is no effect on the net income.

### Check Yourself

In 202, Dell Computer writes off an account receivable from Customer XYZ for 5,000 because XYZ has declared bankruptcy. Which of the following would NOT be true when Dell records this write off?

- A. Dell's allowance account for uncollectible accounts will go down.
- B. Dell's total assets will go down.
- C. Dell's number of customers shown as owing Dell money will go down.
- D. Dell's net income will not change because of the write off.

The answer is B. While the journal entry will debit the allowance account and make it go down and will credit Accounts Receivable to remove the amount owed by XYZ from the list and total of customers owing Dell money, this will not change Dell's total assets since the allowance and accounts receivable are both assets moving in the opposite direction. The bad debt expense and net income will also not be affected.

*Question: In this illustration, at the end of Year One, the company estimated that \$7,000 of its accounts receivable will ultimately prove to be uncollectible. However, in Year Two, that figure is likely to be proven wrong. The actual amount might well be \$6,000 or \$8,000 or many other numbers. When the precise figure is known, does a company return to its Year One financial statements and adjust them to this correct balance?*

*Should a company continue reporting an estimated figure once it has been shown to be incorrect?*

Answer: According to U.S. GAAP, if a number is reported based on a reasonable estimation, any subsequent differences with actual amounts are **not** handled retroactively (by changing the previously released figures). For example, if uncollectible accounts here prove to be \$8,000, the company does not adjust the balance reported as the Year One bad debt expense from \$7,000 to \$8,000. It continues to report \$7,000 for that period even though that number is now known to be wrong<sup>1</sup>.

There are several practical reasons for the accountant's unwillingness to adjust previously reported estimations unless they were clearly unreasonable or fraudulent:

1. Most decision makers are well aware that many reported figures only present estimates. Discrepancies are expected and should be taken into consideration when making decisions based on numbers presented in a set of financial statements. In analyzing this company and its financial health, astute investors and creditors anticipate that the total of bad accounts will ultimately turn out to be an amount around \$7,000 rather than exactly \$7,000.
2. Because an extended period of time often exists between issuing statements and determining actual balances, most parties will have already used the original information to make their decisions. Knowing the exact number now does not allow them to undo those prior actions. There is no discernable benefit from having updated figures as long as the original estimate was reasonable.
3. Financial statements contain numerous estimations and nearly all will prove to be inaccurate to some degree. If exactness were required, correcting each of these previously reported figures would become virtually a never-ending task for a company and its accountants. Scores of updated statements might have to be issued before a "final" set of financial figures became available after several years. For example, the exact life of a building might not be known for fifty years. Decision makers want information that is usable as soon as possible. Speed in reporting is more important than absolute precision.
4. At least theoretically, half of the differences between actual and anticipated results should make the reporting company look better and half make it look worse. If so, the corrections needed to rectify all previous estimation errors will tend to offset and have little overall impact on a company's reported income and financial condition.

Thus, no change is made in financial figures that have already been released whenever a reasonable estimation proves to be wrong. However, differences that arise should be taken into consideration in creating current and subsequent statements. For example, if the Year One bad debts were expected to be 7 percent, but 8 percent actually proved to be uncollectible, the accountant might well choose to use a higher percentage at the end of Year Two to reflect this new knowledge.

*Question: To carry this illustration one step further, assume that \$400,000 in new credit sales are made during Year Two while cash of \$330,000 is collected. Uncollectible receivables totaling \$10,000 are written off in that year. What balances appear in the various T-accounts at the end of the subsequent year to reflect sales, collections, and the write-offs of receivables?*

Answer: Sales and bad debt expense were reported previously for Year One. However, as income statement accounts, both were closed out so as to begin Year Two with zero balances. They are temporary accounts. In contrast, accounts receivable and the allowance for doubtful accounts appear on the balance sheet and retain their ending figures going into each subsequent period. They are permanent accounts. These two T-accounts will still show \$100,000 and \$7,000 respectively at the beginning of Year Two.

Assuming that no adjustments have yet been made, these four accounts hold the following balances at the end of Year Two based on appropriate journal entries. Notice that the expense account remains at zero until the end-of-year estimation is made and recorded.

Figure 2.5 End of Year Two—Sales, Receivables, and Bad Debt Balances

		Sales		
			0	Beginning Balance (Year Two)
			<u>400,000</u>	Credit Sales
			400,000	Ending Balance to Date
		Bad Debt Expense		
Beginning Balance (Year Two)		0		
		Accounts Receivable		
Beginning Balance (Year Two)	100,000			
Credit Sales	400,000	330,000		Cash Collections
		<u>10,000</u>		Accounts Written Off
	<u>500,000</u>	<u>340,000</u>		
Ending Balance to Date	160,000			
		Allowance for Doubtful Accounts		
		7,000		Beginning Balance (Year Two)
Accounts Written Off	<u>10,000</u>			
	<u>10,000</u>	<u>7,000</u>		
Ending Balance to Date	3,000			

**Note that T accounts for income statement accounts start over at zero (are closed to retained earnings) in year 2 while balance sheet accounts (assets and contra assets) carry their balances forward to the new year. Accounts receivable and allowance would be on the asset or left side of the accounting equation and revenues and expenses would be on the right side.**

*Question: In the above T-accounts, the balances represent the account totals for Year Two prior to year-end adjusting entries. Why does a debit balance of \$3,000 appear in the allowance for doubtful accounts prior to the recording of the necessary adjustment? When a debit balance is found in the allowance for doubtful accounts, what does this figure signify?*

*Answer:* When the Year One financial statements were produced, \$7,000 was estimated as the amount of the receivables that would eventually be identified as uncollectible. In Year Two, the actual total written off turned out to be \$10,000. The original figure was too low by \$3,000. We do not go back to the previous year and make the correction but rather the difference is now reflected by the debit remaining in the allowance account. Until the estimation for the new year is determined and recorded (considering the previous balance), the balance residing in the allowance account indicates a previous underestimation (an ending debit balance) or overestimation (a credit) of the amount of worthless accounts.

### Key Takeaways

Bad debt expense is estimated and recorded in the period of sale to correspond with the matching principle. Subsequent write-offs of specific accounts do not affect the expense further. Rather, both the asset and the allowance for doubtful accounts are decreased at that time. If a written off account is subsequently collected, the allowance account is increased to reverse the previous impact. Estimation errors are to be anticipated; perfect predictions are rarely possible. When the amount of uncollectible accounts differs from the original figure recognized, no retroactive adjustment is made if a reasonable estimation was made. Decisions have already been made by investors and creditors based on the original data and cannot be reversed. These readers of the statements should have understood that the information could not possibly reflect exact amounts.

<sup>1</sup>As will be discussed in subsequent chapters, previously issued financial statements are restated if found to contain material misstatements or in a few other specific circumstances. However, a difference between an actual figure and a reasonable estimation

is not handled in this manner. In real life, determining whether a previously reported amount was a reasonable estimation can be the subject of intense debate.

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