

Week 1 - DQ 3

What are the different ways to estimate bad debt?

How does this affect net income?

What does Generally Accepted Accounting Principles (GAAP) require? Why?

Should all companies have bad debt? Explain your answer.

Response #1 Two ways to estimate bad debt are the allowance method and the direct write-off method. The allowance method uses an estimate of the bad debts resulting from the current receivables, recognizing the net realizable value of the receivables on the balance sheet by increasing the 'Allowance for Doubtful Accounts' account to offset the balance in 'Accounts Receivables.' Net income is more accurate with this approach because the estimate of bad debt expense is recorded each period that the sales have taken place, which complies with GAAP requirements. On the other hand, the direct write-off method records a loss once the account has been deemed uncollectible, which will require an entry to decrease 'Accounts Receivables' and increase 'Bad Debt Expense.' Net income is affected once the account becomes uncollectible, which inflates the figure for the periods prior to the write-off of the account. The direct write-off method is simple and direct but does not match the loss to the period in which the revenue was recorded, so it is not recognized by GAAP. All companies should expect and account for bad debt. Fluctuations in the economy and individual circumstances of clients or customers can greatly affect an organization's ability to collect on accounts.

Response #2 Two different ways to estimate bad debt are the percentage-of-sales (income statement) approach and the percentage-of-receivables (balance sheet) approach. The percentage-of-sales approach matches the charge to the period that the company records the sale. The percentage-of-receivables uses net realizable value to report receivables in the balance sheet. This method does not match revenues and cost. Both of these approaches require the company to use past experience when estimating the sales that will become uncollectible. A company will overstate its net income figures if estimating bad debt is not handled properly. The allowance method follows generally accepted accounting principles (GAAP) whereas the direct write-off method does not. Matching expenses and revenues is important as well as determining a carrying value for accounts receivable. The FASB calls receivable collectability a loss contingency. If an asset can be impaired and loss reasonable estimated, the allowance method is the approved GAAP method. The direct write-off method records bad debt in the period when the company decides the debt cannot be collected. It is not matched. Finally, should all companies have bad debt? I don't think they should have bad debts, but I'm sure many do through the course of doing business. It's almost necessary because of purchases that have to be made and receivables

a firm just may not be able to collect on in the end. It is something a company should prepare for recording and including in financial statements.

Reference: *Kieso, D.E., Weygandt, J.J., & Warfield, T.D. (2007). Intermediate Accounting (12th ed.). Hoboken, NJ: John Wiley & Sons*

Response #3 Estimating bad debt expense can be done in several ways. First, a company could use the aging method. This method concludes that the longer a debt is bad, the less likely a company will collect upon it. The second method is the percentage of credit sales method. The third method is percentage of total accounts receivable method. Companies can also use past years bad debt amounts, the economic conditions, etc. Net income is affected by bad debt if the debt is not recorded in the financial reports. If this occurs, the net income will be overstated. GAAP requires that the company provides a provision for doubtful accounts. While most companies should have bad debt, not all companies will. Companies that are based on cash sales (vending machine type companies) wouldn't have bad debt.

Response #4 Different ways to estimate bad debt include a percentage of sales for the prior year and prior bad debt account totals. The net income will be affected by being overstated if bad debt is not recognized. GAAP requires that a company that has significant accounts receivables to provide a doubtful accounts provision and the amount must be a reasonable amount of the receivables that the company feels will not be collected. The GAAP requirements prevent companies from committing fraud by overstating bad debt accounts. All companies that provide sales and services with credit will have bad debt because there will be instances when an account will not be paid, therefore it is necessary for a company to account for bad debt.