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**VALUATION OF ACCOUNTS RECEIVABLE AND
PROVISIONS**

Estimating the value of accounts receivable

Apart from inventory and long-lived assets, also **accounts receivable** must be updated in their value at the end of each accounting period, if necessary.

Companies selling on account bear the risk not to collect all the receivables from their costumers. The **uncollectible accounts** are often called by accountants **doubtful accounts** or **bad debts**.

Remember that according to the **conservatism principle**, losses must be recorded as soon as they are considered probable.

Therefore, at the end of each period companies must estimate the uncollectible accounts and record an expense, which actually represents a loss.

Accounting for uncollectible accounts

In order to account for uncollectible-accounts expense, businesses use one of the following methods:

- **The allowance method**
- **The direct write-off method**

According to **the allowance** method the managers estimate a total bad-debt expense and they record the estimated amounts of uncollectibles by setting up **an allowance for uncollectible accounts**, that is a contra-account related to the accounts receivable (similarly to what we saw for accumulated depreciation).

The accounting entry the businesses make at the end of the period is:

| | | |
|---|-------|-------|
| Uncollectible accounts expense (E) | 1.000 | |
| Allowance for uncollectible accounts (-A) | | 1.000 |

Accounting for uncollectible accounts

According to the **direct write-off method** the companies record the uncollectible-accounts expense and write-off the accounts receivable directly, without using a contra-account.

The accounting entry the businesses make is:

| | | |
|------------------------------------|-------|-------|
| Uncollectible accounts expense (E) | 1.000 | |
| Accounts receivable (A) | | 1.000 |

This method should be used only when the loss, that is the fact that the account is uncollectible, is already certain. In any other case, that is when the loss is only expected, the companies must use the allowance method.

Methods of estimating uncollectible

The most common way to estimate the uncollectible is to examine the business's past records.

There are two basic methods to do this:

- The **percent-of-sales method**
- **The aging-of-accounts-receivable method**

The **percent-of-sales method** computes uncollectible expense at the end of the period as a percentage of net credit sales made during the same period, based on the prior experience of the company. This is called “the income statement approach” since it focuses on the sales of the period.

In the **aging-of-accounts-receivable method** individual accounts receivable from specific customer are analysed according to the length of time they have been receivable from the customer. This is called the “balance sheet approach” since it focuses on accounts receivable reported in the balance sheet.

Recording actual uncollectibles

What happens when we realize that the account is actually uncollectible? Suppose we have an account receivable for 1.000, and an allowance for uncollectibles for 600 related to the same account, estimated at the end of the previous period. When we realize that the receivable is not collectible anymore for the total amount we record:

| | | |
|---|-----|-------|
| Allowance for uncollectible accounts (-A) | 600 | |
| Uncollectible accounts expense (E) | 400 | |
| Accounts receivable (A) | | 1.000 |

Provisions for risks and charges

In order to respect the matching and the conservatism principles, companies are required, in some cases, to record for “provisions”.

Provisions are certain or probable future liabilities for which the amount or timing is not yet known.

When provisions are recorded, an expense is reported in the IS and a special kind of liability is reported in the BS. Both of them are usually called “provisions”.

According to the international accounting standards (IAS 37), companies should record a provision (that is an expense in the IS and a liability in the BS) when:

- a present obligation arising from past events exists and
- the amount of the outflow (necessary to settle the liability) is reliably estimated.

Provisions for risks and charges

Typical examples of provisions are:

- tax litigation liabilities
- legal litigation related to the illegal use of the trademarks or problems arising in contractual agreements (like franchising, licensing, etc.)
- restructuring costs (if some conditions are met)
- cyclical repairing costs on fixed assets (if a contract already exists)
- warranty agreement liabilities

An example: provisions for warranty agreements

In order to better understand how provisions are accounted for, let's make an example related to warranty agreements.

Let's imagine that our company produces cars and guarantees its products for one year later after the sale. Let's hypothesize that during the accounting period X the company recorded revenues for 100.000 € from the sale of cars. According to its past experience, the company estimates that, in the following year, the cost to be borne for the guarantee allowed to the customers amounts to 3.000 €. At the end of the accounting period X the company records:

| | | |
|--------------------------------|-------|-------|
| Warranty provision expense (E) | 3.000 | |
| Provision for warranty (L) | | 3.000 |

An example: provisions for warranty agreements

This accounting entry is consistent with the matching principle, since this cost is related to the revenues that the company has already recorded during the accounting period.

The accounting entry is also consistent with the conservatism principle, since this states that the loss must be recorded even if it is only probable, as soon as we can estimate it.

An example: provisions for warranty agreements

What happens in the accounting period X+1, when the company really bears the cost of the warranty? Let's suppose that the company bears 3.200 € for such costs (it's almost impossible that the provisions' amount corresponds exactly to the amount of the actual cost, since the former is just an estimation). In the accounting period X+1 the company will record:

| | | |
|----------------------------|-------|-------|
| Provision for warranty (L) | 3.000 | |
| Warranty expense (E) | 200 | |
| Cash (A) | | 3.200 |

Estimating the value of “provisions”

The estimation of the amount of provisions we have to account for every accounting period should be based, according to the international accounting standards, on all the information available and on the best estimate the managers can make.

Typically, the estimation is based on the past experience of the company.