Solution:

No, this Is not correct. Why?

Suppose Ford Motors sells a car in July 2013, with a warranty of 3 years. Let’s say the car’s price was $30,000. Then, suppose a person comes on February 2014 for fixation of faulty carburettor, which costs the company around $1,000.

Suppose for the sake of clarity, that the fiscal year for Ford ends on 31 December. Also, let us consider not recording the allowance for warranty.

Then, on 31 December 2013, Ford would have recognized the entire sales as an income. Thus, Ford would have added $30,000 to their sales account.

However, if we see then in reality, the sales have only been $30,000 - $1,000 = $29,000 since the carburettor is assumed to be working fine before. This means we have overstated the income by $1,000.

Moreover, in the next year, the $1,000 that is spent on fixing the carburettor will understate the income by $1,000. Why? This is because this expense is not at all related to any of the transaction in 2014, which means it is essentially immaterial to the income statement of 2014.

This is a clear-cut violation of the matching principle of accounting, which states that all the expenses related to a sale, should be always related to the sales. However, we see here two isolated transactions that distort the income picture.

Thus, to conform with the matching principle of accounting, the companies often create allowance that is based on historical evidence and estimation of the warranty. This is a much better method.