

Bad Debts & Provision for Doubtful Debts

Bad / Irrecoverable debts

When Business sells goods on credit and the debtor doesn't pay us the amount due to us the debt is said to be bad / Irrecoverable. It must be charged to profit and loss as an expense when calculating the profit or loss for the period.

There are a range of possible scenarios that may exist concerning a bad debt:

- The debtor may be refusing to pay one of a number of invoices
- The debtor may be refusing to pay part of an invoice
- The debtor may owe payment on a number of invoices and has indicated that only a proportion of the total amount due will ever be paid because the debtor's business has failed
- The debtor's business has failed and nothing is ever likely to be received.

Double Entry

1) Bad debts	XXX	
	Trade Receivable (Debtor)	XXX
2) Income Statement	XXX	
	Bad Debts	XXX

Provisions for doubtful debts

Provision for Doubtful debts is an estimate by management of the amount that can be turned bad in future.

Provision for Doubtful Debts is made considering factors such as:

- Past Experience
- Specific knowledge about a customer
- The State of the Economy (Recession etc)
- Present Market and Industry conditions
- Consistency concept
- Industry average
- Age of Trade Receivables
- Size of Trade Receivables
- Comparison with previous years or competitors
- Press release about the customer

Bad debts account: This expense account is used when a debt is believed to be irrecoverable and is written off.

Provision for doubtful debts account: This account is used only for estimates of the amount of the Trade Receivables remaining at the year end *after the bad debts have been written off* that are likely to finish up as bad debts. (This account is also known as the 'provision for *bad debts* account'.)

Creating / increasing the provision

Income statement (Exp)	XXX	
Provision for doubtful debts		XXX

Reducing the provision

Provision for doubtful debts	XXX	
income statement (Income)		XXX

Provisions for cash discounts on Trade Receivables

Double Entry

Income statement (Exp)	XXX	
Allowance for cash discount		XXX

Bad Debts Recovered

Double Entry

1) Trade Receivable	XXX	
Bad Debts Recovered (Income)		XXX
2) Bad Debts Recovered (Income)	XXX	
Income Statement		XXX

Bad Debts Account

2015 Mr. A Mr. B	\$	XX <u>XX</u> <u>XXX</u>		2015 Income Statement	\$	 <u>XXX</u>
2016 Mr. C Mr. D		XX <u>XX</u> <u>XXX</u>		2016 Income Statement		 <u>XXX</u>

Bad Debts Recovered Account (Income)

2015 Income Statement	\$	 <u>XXX</u>		2015 Mr. A Mr. B	\$	XX <u>XX</u> <u>XXX</u>
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Provision for Doubtful Debts Account

	\$				\$	
				Balance b/d		XX
				Income Statement (Increase / Exp)		XX
Balance c/d		<u>XXX</u>				<u>XXX</u>
Income Statement (Reduce/ Income)		XX		Balance b/d		XXX
Balance c/d		<u>XXX</u>				<u>XXX</u>
				Balance b/d		XX

INCOME STATEMENT EXTRACT

Gross Profit		XXX
<u>Add: Other Income</u>		
Decrease in allowance for doubtful debts	XXX	
Bad Debts Recovered	XXX	
Decrease in allowance for cash discount	XXX	<u>XXX</u>
		XXX
Less: <u>Expenses:</u>		
Bad debts expense	XXX	
Increase in allowance for doubtful debts	XXX	
Increase in allowance for cash discount	XXX	<u>(XXX)</u>
Profit for the year		<u>XXX</u>

BALANCE SHEET EXTRACT

Current Assets

Trade receivable		XXX
Less: Allowance for doubtful debts	XXX	
Allowance for cash discount	<u>XXX</u>	XXX
Net Receivables		<u>XXX</u>

Q. Identify and explain the relevance of two accounting concepts that must be followed when setting a Provision for doubtful debt account.

A. A provision for doubtful debts is an estimate of the amount which a business will lose in a financial year because of bad debts. At the end of their financial year, many businesses try to anticipate the amount which will be lost because of bad debts. This ensures that the net profit is not over stated and the amount of account receivable in the balance sheet is shown at a realistic level. This is an application of the principle of PRUDENCE. By maintaining a provision for doubtful observes the principle of MATCHING.

Exercises

1.1 ARD Ltd has the following balances in its books

Year	2014	2015	2016
Trade Receivables	100,000	120000	80000

Bad Debts were written off during the year

Mr. A	5000		
Mr. B		3500	
Mr. C			2500

Bad Debts needs to be written off:

Mr. D	4100		
Mr. E			3200

Provision for Doubtful Debts

3%	3.5%	4.5%
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Required

- 1) Bad Debts Account
- 2) Provision for Doubtful Debts Account
- 3) Income Statement Extract
- 4) Statement of Financial Position Extracts

For the years 2014, 2015 and 2016.

Past Paper Questions

- Q1.** Klix Limited's book-keeper prepared the following details about the firm's outstanding trade receivables at 31 December 2010.

Age of debt	Trade Receivables
	\$
Up to 30 days	16 800
31 to 60 days	12 600
61 to 90 days	7 100
Over 90 days	1 300

The following rates are applied for the estimation of doubtful debts.

Age of debt	%
Up to 30 days	1
31 to 60 days	2
61 to 90 days	3
Over 90 days	10

A provision for doubtful debts account is maintained. This had a balance of \$800 on 1 January 2010.

The bad debts written off for the year ended 31 December 2009 amounted to \$1420.

Debbie, a customer who owed the company \$700, has recently been declared bankrupt. This amount had been included in the details above as 'outstanding for 61 to 90 days'. It has been decided to write off the debt immediately.

On 2 October 2010, Harvey, a credit customer, ceased trading and Klix Limited received payment of \$0.25 in the dollar in final settlement of the debt of \$600. The remainder had been written off as a bad debt.

Other bad debts written off during the year ended 31 December 2010 totalled \$350. These had been taken into account when drawing up the list of trade receivables above.

REQUIRED

- (a) Calculate the amount which should be provided as a provision for doubtful debts at 31 December 2010. Show your workings.
- (b) Prepare the following ledger accounts for the year ended 31 December 2010, showing the closing entry to the final accounts at the end of the year.
- (i) Provision for Doubtful Debts
- (ii) Bad Debts Account
- (iii) Harvey Account
- on 30 Nov 2010 John, whose debt of \$5000 had been written off in 2009, returned and paid \$0.55 for each dollar written off.
- (c) Prepare an extract from the statement of financial position (balance sheet) at 31 December 2010 showing the net amount of trade receivables.

Klix Limited's directors are reviewing the existing policy for calculating the provision for doubtful debts.

They are considering applying a 4% rate to all debts as the basis for calculation.

REQUIRED

- (d) (i) Calculate the effect of this change on the provision for doubtful debts.
- (ii) Explain how this change would affect the company's income statement and statement of financial position.
- (iii) Explain why this change might be necessary.
- (e) State **three** factors that the directors should consider when creating a provision for doubtful debts.
- (f) Enter the Journal Entries to record bad debt recovered and prepare bad debts recovered account.

Q2. During the year ended 31 March 2007 Jeremiah lost money through customers not paying the amounts due to him. On 1 April 2007 he set up a provision for doubtful debts account.

REQUIRED

- (a) (i) Give **one** reason why Jeremiah decided to set up this account.
- (ii) Describe **two** factors Jeremiah might consider when deciding the amount to be provided for in the provision for doubtful debts account.
- (iii) Explain the difference between the accounting treatment of a bad debt and a doubtful debt.

On 1 April 2008, Jeremiah's provision for doubtful debts account had a balance of \$8000. This consisted of an anticipated loss of \$2500 which was the total owed by a debtor, Uriah, who had been declared bankrupt, and a general provision of \$5500, which was 2½% of **all** of his debtors.

On 31 May 2008 Liew, who owed Jeremiah \$1200, paid Jeremiah only \$0.40 for every dollar owed. The remainder was written off as a bad debt.

On 30 June 2008, Uriah paid Jeremiah \$0.35 for every dollar owed, in **final** settlement of his account.

On 28 February 2009 Jeremiah wrote off \$300 of overdue debts from various debtors.

On 31 March 2009 Jeremiah's total debtors amounted to \$205 000 and he adjusted his provision for doubtful debts account to 3% of that amount.

REQUIRED

- (b) Prepare in Jeremiah's ledgers the following accounts for the year ended 31 March 2009.
- (i) Provision for doubtful debts account;
 - (ii) Bad debts account.

On 31 March 2009 Khalil, whose debt of \$3000 had been written off in 2007, after he unexpectedly left the country, returned and paid the amount due.

REQUIRED

- (iii) Prepare in Jeremiah's ledgers the bad debts recovered account for the year ended 31 March 2009.

Q3. Explain why a provision for doubtful debts may be necessary.

Bradley provides for doubtful debts at the rate of 4%.

The provision for doubtful debts at 1 April 2013 was \$1650.

Trade receivables at 31 March 2014 were \$35000.

REQUIRED

- (f) Prepare Bradley's provision for doubtful debts account for the year ended 31 March 2014.
- (g) State how the provision for doubtful debts is shown in:
 - (i) income statement
 - (ii) statement of financial position

Q4 Raymond Bow prepared the following aged debtors schedule for his business on 31 March 2009.

Debtor	Amount due £	1 month £	2 months £	3 months £	4-6 months £	Over 6 months £
Peter White	2 500	2 200	300			
Janet Black	5 400	3 300	1 400	700		
John Green	5 880	1 600	1 880	1 800	600	
Susan Yellow	160					160
Sunil Orange	2 620	1 000	620	500	500	
Jose Violet	300				90	210
Bret Purple	190				150	40
Carlos Blue	4 680	2 000	1 800	800		80
	<u>21 730</u>	<u>10 100</u>	<u>6 000</u>	<u>3 800</u>	<u>1 340</u>	<u>490</u>

The provision for doubtful debts as at 1 April 2008 was £1 890.

Jose Violet has recently been declared bankrupt. Raymond Bow has received payment of £0.25 in the £ in final settlement of the debt. The final settlement has not yet been processed through the accounts. The remainder of the amount due is to be treated as a bad debt.

Raymond Bow's policy for dealing with outstanding debtors is to:

- (i) write off as bad debts all amounts outstanding for more than six months;
- (ii) write off as bad debts all amounts under £200 outstanding for between four to six months;
- (iii) make specific provisions for all the other debts outstanding for between four to six months;
- (iv) make a general provision of 3% on all the remaining outstanding debts.

REQUIRED

- (a) Prepare the following ledger accounts of Raymond Bow for the year ended 31 March 2009, showing where appropriate the closing entry to the final accounts at the end of the year.
 - (i) Jose Violet. [3]
 - (ii) Bret Purple. [2]
 - (iii) Bad Debts. [6]
 - (iv) Provision for Doubtful Debts. [4]
- (b) The Profit and Loss Account extract for Bad Debts and Provision for Doubtful Debts for the year ended 31 March 2009. [2]
- (c) The Balance Sheet extract for Debtors as at 31 March 2009. [2]
- (d)* Discuss the reasons why a business needs to monitor and control its debtors. [10]
- (e) Explain two factors used in determining the provision for doubtful debts. [4]

Total marks [33]

Q5 The following is an extract from the Trial Balance of Daniel Denong as at 31 March 2009.

	Dr £	Cr £
Debtors	144 000	
Provision for doubtful debts		4 200
Bad debts	2 400	

One debtor included in the debtors balance above is Y. Ara. She has recently been declared bankrupt, and is unable to pay her account of £1 600. This amount is to be treated as a bad debt.

R. Iver, a debtor also included in the above debtors balance, has ceased trading. Daniel Denong has now received £0.20 in the pound in final settlement of R. Iver's debt of £800. The remainder of the debt is to be written off in full as a bad debt.

The provision for doubtful debts is then to be adjusted to provide for a specific debt of £1 200 owed by B. Lorratt, plus a general provision of 2.5% of the remaining debtors.

REQUIRED

- (a) The following ledger accounts for the year ended 31 March 2009, showing, where appropriate, the transfer to the final accounts at the end of the year.
- (i) Bad Debts. [4]
 - (ii) Provision for Doubtful Debts. [4]
 - (iii) R. Iver. [3]
- (b) The Balance Sheet extract as at 31 March 2009 for debtors (net). [2]
- (c) Discuss two reasons why a business should create a provision for doubtful debts. [4]
- (d) Discuss two factors that a business should consider when creating a provision for doubtful debts. [6]

Total marks [23]

Q6 Jade Shepherd prepared the following aged debtors schedule for her business on 30 September 2010:

Debtor	Amount due £	Up to 30 days £	31–60 days £	61–90 days £	91–180 days £	Over 180 days £
Sam West	850			150		700
Brock Tan	225	175		50		
Alf Springer	550					550
Ian Bull	800	220	355	150	75	
Angus Scott	195					195
Lilly Parsons	437		86	351		
Lucy Lockett	115					115
Ruby Golden	528	105	209	49	165	
	3700	500	650	750	240	1560

The provision for doubtful debts as at 1 October 2009 was £435.

Jade Shepherd has recently discovered that Sam West has ceased trading. Jade has decided to write off as a bad debt the total owed by Sam West.

Jade Shepherd's policy for dealing with outstanding debts is to:

- (i) write off as bad debts all amounts outstanding for over 180 days;
- (ii) make specific provisions for all debts outstanding between 91 and 180 days;
- (iii) make general provisions as follows:
 - 1% of debts outstanding for up to 30 days
 - 2% of debts outstanding for 31 to 60 days
 - 3% of debts outstanding for 61 to 90 days

REQUIRED

- (a) Prepare and balance off the following ledger accounts for Jade Shepherd for the year ended 30 September 2010. (Dates are not required).
 - (i) Sam West. [2]
 - (ii) Ruby Golden. [1]
 - (iii) Bad Debts. [4]
 - (iv) Provision for Doubtful Debts. [3]
- (b) The Profit and Loss Account extract for Bad Debts and Provision for Doubtful Debts for the year ended 30 September 2010. [3]
- (c) The Balance Sheet extract for Debtors as at 30 September 2010. [2]
- (d) Define two accounting concepts which should be applied when accounting for doubtful debts. Explain how each of these concepts should be applied when preparing final accounts. [8]
- (e)* Jade Shepherd is considering changing her existing policy in relation to outstanding debts. She plans to continue her existing policy for writing off bad debts; however, she now plans to apply a single 5% provision to all remaining debts.

Recommend and justify which would be the most suitable policy. You should use figures to support your recommendation. [10]

(f) Identify **two** ways in which Jade Shepherd could reduce bad debts. [2]

Total marks [35]

Q7 Arif runs a small business with total annual sales of £30 000. He has been reviewing his debtors and has provided the following information as at 30 September 2012.

	Total £	0–1 month £	2–3 months £	4–6 months £	7–12 months £	Over 12 months £
Noel	1 410	1 100	310			
Sangita	3 400					3 400
Jason	770			550	220	
Benaz	565	375	190			
Other Debtors	5 670	5 670				
	<u>11 815</u>	<u>7 145</u>	<u>500</u>	<u>550</u>	<u>220</u>	<u>3 400</u>

Arif's terms of trading are payment within 30 days.

The provision for doubtful debts as at 1 October 2011 was £700.

Arif's policy for overdue and bad debts is to:

- (i) write off as a bad debt any debt outstanding for over 12 months.
- (ii) create specific provisions for any debts outstanding for between 4 and 12 months.
- (iii) make no provision for doubtful debts up to 1 month old.
- (iv) create a general provision of 3% of all other debts.

REQUIRED

(a) Prepare and balance off the following ledger accounts for Arif for the year ended 30 September 2012:

- | | |
|-----------------------------------|-----|
| (i) Sangita | [1] |
| (ii) Jason | [1] |
| (iii) Bad debts | [2] |
| (iv) Provision for doubtful debts | [5] |

(b) The Profit and Loss Account extract for bad debts and provision for doubtful debts for the year ended 30 September 2012. [2]

(c) The Balance Sheet extract for debtors as at 30 September 2012. [4]

(d)* Evaluate Arif's policy for overdue and bad debts. [12]

(e) (i) Explain what is meant by:

- cash discount;
 - trade discount.
- [4]

(ii) Compare the treatment of cash discount and trade discount in a set of accounts. [6]