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		XXX
2) Income Statement		XXX	
	Bad Debts		XXX

<u>Provisions for doubtful debts</u>
Provision for Doubtful debts is an estimate by management of the amount that can be turned bad in future.

<u>Provision for Doubtful Debts in made considering factors such as:</u>

- 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 debtors
- Size of debtors
- 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 debtors 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 (Expense)	XXX	
Provision for doubtful debts		XXX

Reducing the provision

Provision for doubtful debts	XXX	
income statement (Income)		XXX

<u>Bad Debts Recovered</u>

Double Entry

1) Trade Receivable / Bank	XXX	
Bad Debts Recovered (Income)		XXX

2) Bad Debts Recovered (Income)	XXX	
Income Statement		XXX

Bad Debts Recovered Account (Income)

2015	$	**2015**	$
		Mr. A / Bank	XX
		Mr. B / Bank	<u>XX</u>
Income Statement	<u>XXX</u>		<u>XXX</u>

Bad Debts Account

2015	$	**2015**	**$**
Mr. A	XX		
Mr. B	XX		
	XXX	Income Statement	XXX
2016	XX	**2016**	
Mr. C	XX		
Mr. D	XXX	Income Statement	XXX

Provision for Doubtful Debts Account

	$		**$**
		Balance b/d	XXX
		Income Statement (Increase / Expense)	XXX
Balance c/d	**XXX**		**XXX**
		Balance b/d	XXX
Income Statement (Decrease / Income)	XXX		
Balance c/d	**XXX**		**XXX**
		Balance b/d	XXX

INCOME STATEMENT EXTRACT

Gross Profit	XXX
Add: Other Income	
Decrease in Provision for doubtful debts	X
Bad Debts Recovered	X
Less: Expenses:	
Bad debts expense	(XXX)
Increase in Provisions for doubtful debts	(XXX)

STATEMENT OF FINANCIAL POSITION EXTRACT

Current Assets

Trade receivable (After Bad Debts)	XXX
Less: Provision for doubtful debts	(XXX)
	XXX

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.

Q1 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%

Required

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

For the years ended 31 Dec 2014, 2015 and 2016.

Q2 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.

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(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 account

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(ii) Bad debts account

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(iii) Harvey account

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on 30 Nov 2010 John, whose debt of $5000 had been written off in 2009, returned andpaid $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.

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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.

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(ii) Explain how this change would affect the company's income statement and statement of financial position.

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(iii) Explain why this change might be necessary.

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(e) State **three** factors that the directors should consider when creating a provision for doubtful debts.

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(ii) ....

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(iii) ....

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(f) Make the Journal Entries to record bad debt recovered.

Q3 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.

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(ii) Describe **two** factors Jeremiah might consider when deciding the amount to be provided for in the provision for doubtful debts account.

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(iii) Explain the difference between the accounting treatment of a bad debt and a doubtful debt.

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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;

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(ii) Bad debts account.

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