

Bad Debts

Theory

What is a bad debt?

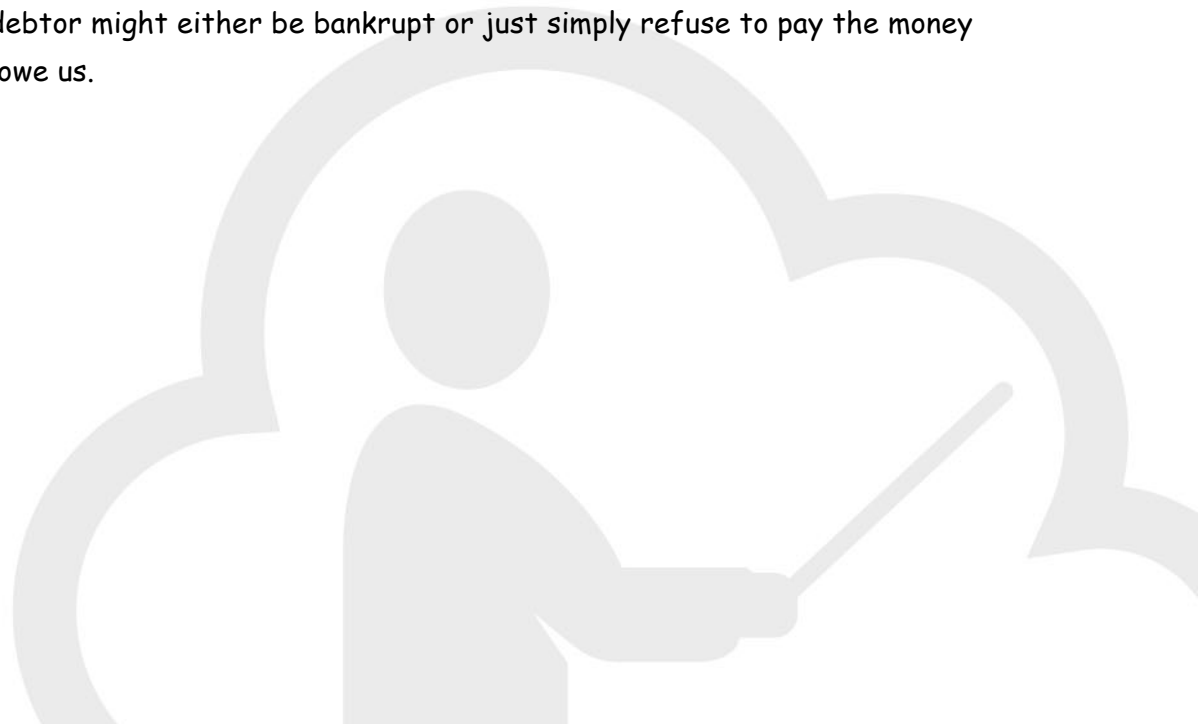
Bad debts occur when the debtor (person who owes us money) is either unwilling or unable to repay the amount they owe us. A debt becomes **bad** when in the opinion of the seller it will not be recovered.

Our balance sheet is expected to show a true and fair view of the business and so it would be misleading to include **bad debtors** as assets on the balance sheet if they aren't expected to pay. Therefore they should be removed from the balance sheet as soon as possible.

We are able to do this by transferring the **bad debt** from our debtors ledger account to a **bad debts** account and then to the profit and loss account where the bad debt is charged against our profits. We carry these transfers out through using journal entries.

Remember a bad debt is:

- Is the amount of money owed by a debtor that is uncollectable at the present time.
- The debtor might either be bankrupt or just simply refuse to pay the money they owe us.



Bookkeeping

Double Entry Rules:

Debit bad debts account
 Credit debtor's account } With each unpaid debt

Debit profit and loss account
 Credit bad debts account } With the total of unpaid debts

Q 4.1

On 1/1/2015, Jay Watson, a sole trader, found out that J. Fulton, who owed him €500, was unable to pay his debt. As a result he decided to write it off in full.

You are asked to show:

- The journal entries, ledger entries and an extract from the profit and loss account.

Journal	Dr.	Cr.
Bad Debts	€ 500.00	
J. Fulton		€ 500.00
(being write off of debt owed by J. Fulton)		

J. Fulton Account					
Jan-01	Balance b/d	€ 500.00	Dec-31	Bad Debts a/c	€ 500.00
		€ 500.00			€ 500.00

Profit & Loss Extract for year ended 31/12/2010				
Expenses:				
	Bad Debts	€ 500.00		

Bad Debts Account					
Jan-01	J. Fulton	€ 500.00	Dec-31	Profit & Loss a/c	€ 500.00
		€ 500.00			€ 500.00

Bad Debts Provision

We are aware as a business that every year a certain percentage of debtors will not pay the amounts owed by them. For one reason or another certain amounts of debts will be declared bad.

As well as having a bad debts account to which we will transfer the **actual** bad debts as they arise, the business will also have a provision for bad debts account. This is where we will enter the estimated amount of debts which are deemed to be **bad**.

Remember a provision for a bad debt is;

- A provision for a bad debt is created when the owner of a business expects a certain amount of debts to become bad.
- It is only an estimate and they are not bad debts until the debtor does not pay.
- This provision is shown as a deduction from debtors in the balance sheet.

How do we estimate an amount?

1. We take a percentage of the total figure for our debtors.
2. We look through the debtors and select those that are likely to be bad.
3. Some debtors are allowed longer periods of credit than others, we keep this on a list. The List of Credit Periods Allowed of Debtor's is used to apply a different percentage to different credit periods. The longer the debt is due, the higher the percentage rate applied to that period.



Bookkeeping

Double Entry Rules:

Debit profit & loss account

With just one

1. The creation of a provision for bad debts
2. Any increase in the old provision

Credit provision for bad debts account

Debit provision for bad debts account

} With any decrease in the old provision

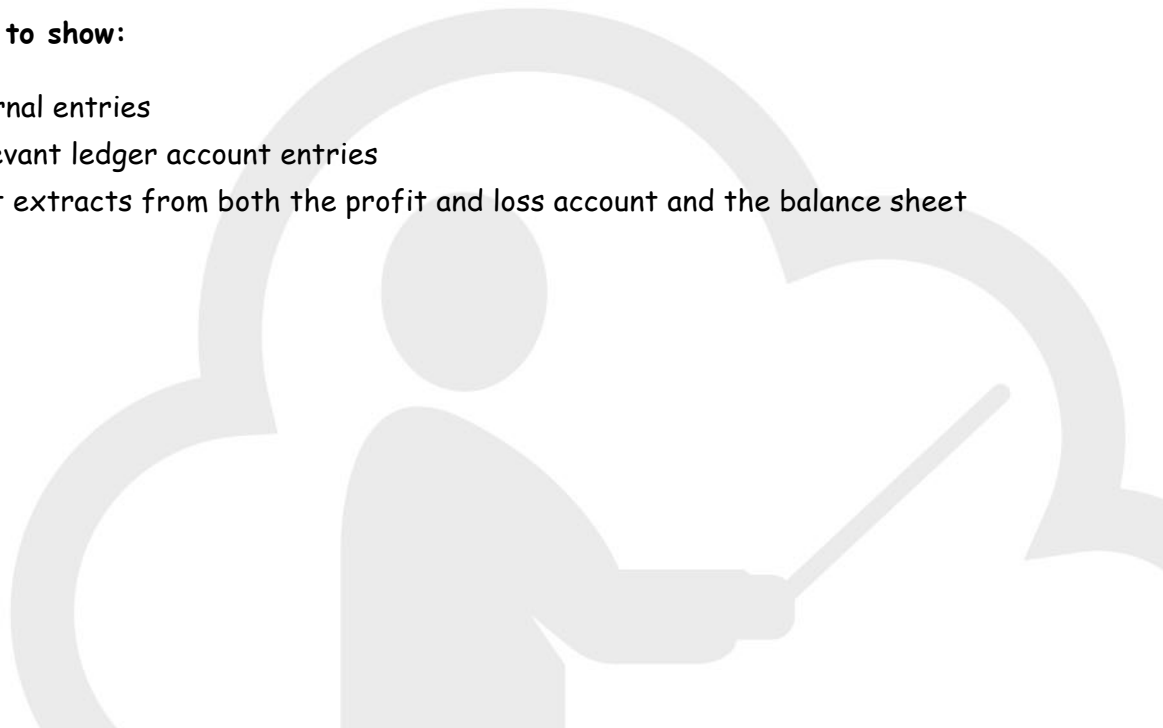
Credit profit & loss account

Q 4.2

On 1/1/2014, M. Knight had debtors of €6,000. At 31/12/2014, R. Johnson's debt of €1,500 was written off as bad. As at 31/12/2014 M. Knight had debtors of €7,000 and it was decided that the provision for bad debts should be adjusted to 2% of that figure.

You are asked to show:

- The journal entries
- The relevant ledger account entries
- Relevant extracts from both the profit and loss account and the balance sheet



Journal	Dr.	Cr.
Bad debt s account	€ 1,500.00	
R.J ohnson		€ 1,500.00
Being write off of debt owed by R.J ohnson		
Profit & Loss	€ 1,500.00	
Bad debt s account		€ 1,500.00
Being transfer to profit and loss acc		
Provision for bad debt s account	€ 140.00	
Profit and Loss Acc		€ 140.00
Being the creation of a provision account		

R.J ohnson Account					
J an-01	Balance b/d	€ 1,500.00	Dec-31	Bad Debt s account	€ 1,500.00
		€ 1,500.00			€ 1,500.00

Provision for Bad Debt s Acc					
			Dec-31	Profit & Loss Acc	€ 140.00
Dec-31	Balance c/d	€ 140.00			
		€ 140.00			€ 140.00
			J an-01	Balance b/d	€ 140.00

Profit & Loss	
Expenses:	
Bad Debt s	€ 1,500.00
Provision for bad debt s	€ 1,400.00

Balance Sheet	
Current Asset s:	
Debt ors	€ 7,000.00
Less Bad debt s provision	€ 140.00
	€ 6,860.00

Reducing & Increasing Provision for Bad Debts

Reducing the provision for bad debts:

Sometimes the existing provision for bad debts is too much. If this situation arises it's reasonable to write some of it back and as a result reduce the provision to reflect the reality of our bad debts.

To do this we;

- Debit the bad debts provision account
- Credit the profit and loss account with the amount of the reduction

Increasing the provision for bad debts:

Sometimes we may want to increase the provision for bad debts as we may realise that our current provision is insufficient. If this situation occurs then it is reasonable to increase our bad debt provision.

To do this we;

- Debit the profit and loss account
- Credit the provision for bad debts account the amount of the increase by journal entry

Bad Debts Recovered

Sometimes a debtor whose debt has been written off as bad pays of part or all of their debt. We handle this in the following way;

1. Debit debtor account

Credit bad debts recovered account

} *With the amount of the debt*



2. Debit bank account

} With the amount received

Credit debtor account

3. Debit bad debts recovered account

} With each unpaid debt

Credit profit and loss account

Q 4.3

A bad debt amounting to €300 which was owed by John Smith and written off as bad in 2014 had subsequently been paid by Smith in full on 31/10/2015.

You are asked to show;

- The journal entries.
- The relevant ledger account entries.
- Relevant extracts from the profit and loss account.

Journal	Dr.	Cr.
Debtor account	€ 300.00	
Bad debts recovered account		€ 300.00
Being resintatement of debt owed by Smith		
Bank account	€ 300.00	
Debtor account		€ 300.00
Being amount paid by debtor		
Bad debts recovered account	€ 300.00	
Profit & Loss account		€ 300.00
Being the creation of a provision account		

John Smith Account			
Oct-01	Bad debts recovered	€ 300.00	
		€ 300.00	
Oct-31	Bank Account		€ 300.00
			€ 300.00

Bad Debt s Account			
Dec-31	Profit & Loss account	€ 300.00	
		€ 300.00	
Oct-31	Smith		€ 300.00
			€ 300.00

