Bad debts & Provision for doubtful debts

Bad debts, Doubtful debts and Provision for doubtful debts

Bad debts are basically the debtors which confirm to be irrecoverable. In other words, collection from debtors if clearly becomes uncollectable called as bad debts. As the bad debts are confirmed to be uncollectable so bad debts should be removed from the debtors account for reporting net realizable value of debtors. However, a doubtful debt is also the debtors whose collection may or may not be collected at specific point in time in future. We are not sure about the collection from debtors so called as doubtful debts. By following the prudence concept we make provision for doubtful debts so that income and asset should not be overstated. Provision for doubtful debt is the estimated value of debt which may not be collected from customers during the financial year. It is contra account of debtors so it should be deducted from debtors to represent the net realizable value of debtors in balance sheet.

How can we reduce the possibility of bad debts?

- Reducing the credit limit
- Offering cash discount
- Regular visit
- Monitoring the customer behavior and act accordingly
- Legal action a more extreme measure

How can we establish the amount of provision for doubtful debt?

- Regularly check the record of each debtor and estimate which debtor will <u>not</u> pay off his/her debt.
- Estimate on the basis of past experience. Percentage of amount due which will not be collected yet.
- Check the time length of each debtor by means of aging schedule. Older debts should be higher percentage for provision and vice versa because the chance for risk of bad debts is more for longer period outstanding debts.

An example to understand the accounting treatment

Following trial balance is available of Mr. Akram's business. Relevant figures to the topic are highlighted and some tips are also mentioned in given boxes to understand the topic more clearly.

Mr. Akram
Trial Balance
As on March 31, 2017

S. No.	Account Names	Account Code No.	Debit Rs.	Credit Rs.
1	Cash account	1	790,000	
2	Machinery account	2	700,000	
3	Capital account	3		1,400,000
4	Purchases account	4	180,000	
5	Trade creditors account	5		75,000
6	Sales account	6		350,000
7	Trade debtors account	7	135,000	
8	Bad debts account	8	15,000	
9	Salaries account	9	10,000	
	Provisions for doubtful debts account			6,000
			1,830,000	1,830,000

Balance of debtors after deducting all old bad debts

Old bad debts

Old provision for doubtful debs

New bad debts

Adjustments:

Further bad debts found to be written off for Rs. 35,000. It is decided to create a provision for doubtful debts at 10% of trade debtors.

New provision rate for doubtful debts

Required:

1. **Prepare the following accounts in the books of Mr. Akram**
   - **Bad debts account**
   - **Provision for doubtful debts account**
   - **Trade debtors account**
2. **Show the effect of above accounts in financial statements**

Following entry has already been made for bad debts given in trial balance. So there is no need to pass the journal entry for old bad debts again. Just for understanding the entry is given below.

Bad debts a/c	15,000	
To Trade debtors a/c		15,000

However, following entry should be made in the books of accounts to close the bad debts account given in Trial balance.

Profit and loss a/c	15,000	
To Bad debts a/c		15,000

Entries to write off or further bad debt or new bad debts made at the end of year given in adjustment for Rs. 20,000

To write off the debtor account

Bad debts a/c	35,000	
To Trade debtors a/c		35,000

To close bad debts account

Profit and loss a/c	35,000	
To Bad debts a/c		35,000

Bad debts account						**A/C Code No. 01**	
Debit							**Credit**
Date	**Particulars**	**J.R**	**Amount Rs.**	**Date**	**Particulars**	**J.R**	**Amount Rs.**
	Trade debtors a/c (old bad debts)		15,000		Profit & loss a/c (old bad debts)		15,000
	Trade debtors a/c (write off)		35,000		Profit & loss a/c (new bad debts)		35,000
			50,000				50,000

Calculation of provision for doubtful debts to date or closing balance or Balance c/d of provision for doubtful debts if provision for doubtful debt is to be maintained or increased to/at 10% as given in question.

= (Trade debtors given in Trial balance – New bad debts given in adjustments) x Rate of new provision given in adjustments

= (135,000 – 35,000) x 10/100

= 100,000 x 10/100

= Rs. 10,000 (also called as contra asset which would be deducted from debtors for reporting in balance sheet)

Note: calculated amount of Rs. 10,000 will be charged to income statement if sentence is given as provision for doubtful debts increased by 10%

Provision for doubtful debts account							**A/C Code No. 02**
Debit							**Credit**
Date	**Particulars**	**J.R**	**Amount Rs.**	**Date**	**Particulars**	**J.R**	**Amount Rs.**
					Balance b/d (Old provision taken from trial balance)		6,000
	Balance c/d (New provision to date)		10,000		Profit & loss a/c (Balancing figure)		4,000
			10,000				10,000

Change in provision:

= New provision – Old provision or

= Balance c/d – Balance b/d

= 10,000 – 6,000

= 4,000 it represents the increase in provision

Entry for increase in provision for doubtful debts:

Profit & loss a/c 4,000
To Provision for doubtful debts a/c 4,000
Note: Reverse entry will be passed in case of decrease in provision for doubtful debt

Note:

- **Balance b/d > Balance c/d: Need to decrease the provision (reported in income statement as income)**
- **Balance b/d < Balance c/d: Need to increase the provision (reported in income statement as expense)**

Trade debtors account							**A/C Code No. 03**
Debit							**Credit**
Date	**Particulars**	**J.R**	**Amount Rs.**	**Date**	**Particulars**	**J.R**	**Amount Rs.**
	Balance b/d (Value taken from Trial balance)		135,000		Bad debts (written off or new bad debts)		35,000
					Balance c/d		100,000
			135,000				135,000

Note: Bad debts given in trial balance should not be debited to this account because this amount has already been deducted from opening balance or balance b/d of trade debtors given in trial balance.

Representation in Financial Statements

Income Statement

- All bad debts charged as expenses: 15,000 + 35,000 = Rs. 50,000
  (Taken from bad debts account)

- Provision for doubtful debts charged to expense account because of *increase in provision*: Rs. 4,000 (Taken from provision for doubtful debts account)
  Note: Provision for doubtful debts treated as income if *decreased*

- Total amount charged to income statement is Rs. 50,000 + 4,000 = 54,000

Balance Sheet

- ***Net realizable value of trade debtors should be reported in balance sheet which is calculated as:***

  Trade debtors given in trial balance – New bad debts written off – closing balance of new provision for doubtful debts: 135,000 – 35,000 – 10,000 = Rs. 90,000

  Or

  Trade debtors balance c/d taken from trade debtor's account – closing balance of new provision for doubtful debts: 100,000 – 10,000 = Rs. 90,000

TRADITIONAL APPROACH FOR DEALING BAD DEBTS AND PROVISION FOR DOUBTFUL DEBTS

Provision for doubtful debts reported in profit and loss account:

= New provision (Given in adjustments) + Old bad debts (Given in trial balance) + New bad debts (Given in adjustments) – Old provision (Given in trial balance)

*If the information of a particular item is not given then put the value "0" or nil amounts in the above formula in order to calculate provision for doubtful debts to be reported in profit and loss account.

* If the answer is positive then it is reported as an expense otherwise it is reported as other income.

If the new provision is not given but possible to calculate with information given in adjustments then it will be calculated as:

New provision = (Sundry debtors – New bed debts) x rate of new provision given in adjustment

*Note: Above calculation will be charged directly to income statement if sentence is given as provision for doubtful debts increased **<u>by</u>** 10%*

Amount of sundry debtors (net realizable value) reported in balance sheet:

Sundry Debtors	xxx	
Less: New provision	(xxx)	
Less: New bad debts	<u>(xxx)</u>	<u>xxx</u>

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Note: Please consult recommended books mentioned in "books" Tab of VU-LMS for more practice.