Chapter 14 Accounting for Bad Debts

- Understanding Bad Debts
- Accounting for Bad Debts Using Direct Write-off Method
- Accounting for Bad Debts Using Allowance Method

Bad Debts

- An accounts receivable that for one reason or another cannot be collected (uncollectible)

- When a receivable is considered uncollectible, the balance of the customer's account is "written off" the books.

  - ✓ The write-off is not recorded as a reduction in revenue

  - ✓ It is recorded as an operating expense

  - ✓ **Bad Debts Expense:** the account used to record the uncollectible account

The Direct Write-Off Method for Bad Debts

- Records the expense for bad debts only when a customer's account is determined to be uncollectible, this is so-called direct charge-off method.
- Assume Beck Supply Company uses the direct write-off method. On September 14, Beck received notice the Country Pub had declared bankruptcy. The $600 balance owed to Beck by Country Pub needs to be written off. Beck Supply Company records the following entry.

Sept. 14	Bad Debts Expense	600	
	Accounts Receivable—Country Pub		600

Partial Payment Under the Direct Write-Off Method

- Assume in the previous slide that on September 14 Country Pub is able to pay $100 of the $600 it owes Beck Supply Company.
- Beck Supply Company prepares the following journal entry to record receipt of $100 and a write-off of the remainder of the amount owed.

Sept. 14	Cash	100	
	Bad Debts Expense	500	
	Accounts Receivable—Country Pub		600

Recovery of Bad Debts

- Occasionally, a bad debt will be recovered at a later date, so how to account for the recovery depends on timing:

  ✓ During *the same accounting period* as the write-off

  ✓ In a later period

Assume the following entry was prepared on April 4 by Bergwell Equipment Company to write off the balance of Ed Cross's account.

Apr. 4	Bad Debts Expense	600	
	Accounts Receivable — Ed Cross		600

- On Dec. 2, Ed made full payment of the $600 owed to Bergwell. Bergwell records the following entry to reverse the write-off entry.

Dec. 2	Accounts Receivable — Ed Cross	600	
	Bad Debts Expense		600

Dec. 2	Cash	600	
	Accounts Receivable—Ed Cross		600

Recovering Bad Debts in a Later Period

- Assume the following entry was prepared on April 4 by Bergwell Equipment Company to write off the balance of Ed Cross's account.

20X1 Apr. 4	Bad Debts Expense	600	
	Accounts Receivable — Ed Cross		600

- On Jan. 24 of the following year, Bergwell receives payment from Ed Cross for the entire amount. Bergwell prepares the following entries on January 24 to reinstate Ed Cross's account and receive cash.

Example: Recovering Bad Debts in a Later Period

20X2 Jan. 24	Accounts Receivable — Ed Cross	600	
	Recovery of Bad Debts		600

20X2 Jan. 24	Cash	600	
	Accounts Receivable — Ed Cross		600

Discussion: Direct Write-Off Method

- Used mainly by professional firms and small merchandising businesses that do not get a significant portion of their revenue from credit sales.
- Its use could result in an improper matching of revenue and expenses, for businesses with a large volume of credit sales.
- Under this method if a receivable from a credit sale becomes uncollectible in a later accounting period, it is written off in that later period.
  - ✓ The revenue from the sale is recorded in one period.
  - ✓ The bad debt that results from the sale is recorded in a later period.

Recording the Write-Off of a Customer's Account Using the Allowance Method

- On January 17, 20X2, Nichols Company received notice that Richard Kingrey had declared bankruptcy.
- Nichols records the following entry to write-off Kingrey's $300 balance.

20X2 Jan. 17	Allowance for Doubtful Accounts	300	
	Accounts Receivable - Richard Kingrey		300

Allowance for Doubtful Accounts

- The Allowance for Doubtful Accounts debited
  - ✓ Rather than the Bad Debts Expense account
  - ✓ Because the expense account was debited at the end of the period in which the credit sales occurred
  - ✓ Not necessary to debit the Bad Debts Expense account again
- The write-off of a customer's account removes its balance from the general ledger and the accounts receivable ledger.
- The net realizable value of the receivables is unchanged, because both the contra asset account and the accounts it relates to were reduced by the same amount.

Illustration

	Balance before write-off	Balance after write-off
Accounts Receivable	$40,000	$39,700
Allowance for Doubtful Accounts	– 2,700	– 2,400
Net Realizable Value	$37,300	$37,300

Allowance Method: Estimating Bad Debts Using the Income Statement Approach

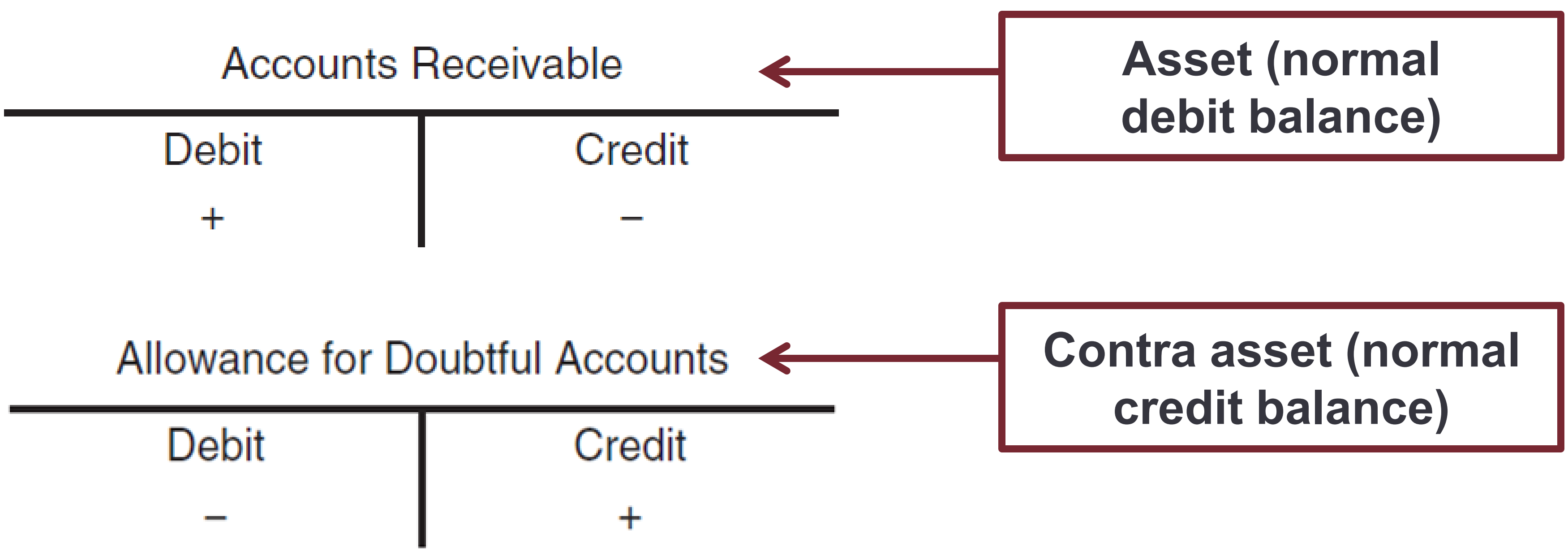
- Under the income statement approach, the amount of credit sales for the period is multiplied by an estimated rate of bad debts. The estimated rate is usually based on the past experience of the business.

- Assume the Nichols Company has $90,000 of credit sales during 20X1 and estimates 3% will be uncollectible. The bad debts expense is estimated to be $90,000 × .03 = $2,700. An adjusting entry is prepared at the end of the year to account for the estimated bad debts.

20X1 Dec. 31	Bad Debts Expense	2,700	
	Allowance for Doubtful Accounts		2,700

Adjusting Entry for Bad Debts Under the Allowance Method

- The *Allowance for Doubtful Accounts* is a contra asset with a credit balance. On the balance sheet, it is subtracted from the balance of *Accounts Receivable.* The difference between the two balances is the *net realizable value*, sometimes called *net receivables.*



Estimating Bad Debts Using the Balance Sheet Approach

- A second approach to estimate bad debts
- Based on a process called *aging the receivables*; aging means to determine exactly how long each customer's unpaid balance has been outstanding
- Unpaid balances are put into age categories such as
  - ✓ Not yet due
  - ✓ 1–30 days past due
  - ✓ 31–60 days past due
  - ✓ 61–90 days past due

Aging Schedule

Epson Supply Company
Aging Schedule
December 31, 20X1

Customer	Total	Not Yet Due	Number of Days Past Due					
			1–30	31–60	61–90	91–180	181–365	Over 365
Carson, Rob	990 00	990 00						
Defrin, Jill	475 00		475 00					
Estavan, Lynn	565 00				565 00			
Gershon, Ned	235 00					235 00		
Zimmer, Kay	580 00		580 00					
Total	44 990 00	30 000 00	8 000 00	4 000 00	1 500 00	600 00	—	890 00
Estimated rate		× .02	× .05	× .10	× .22	× .50	× .70	× .80
Total estimated uncollectible accounts	2 742 00	600 00	400 00	400 00	330 00	300 00	—	712 00

Adjusting Entry Based on Aging Schedule

- Based on the aging schedule in the previous slide, Epson Supply Company estimates that $2,742 of receivables will be uncollectible.

- This is the first year of operations for Epson Supply, so there is no previous balance in the *Allowance for Doubtful Accounts* account.

Dec. 31	Bad Debts Expense	2,742	
	Allowance for Doubtful Accounts		2,742

Determining the Adjusting Entry When the Allowance for Doubtful Accounts Account Has a Previous Balance

- In the previous notes, the Allowance for Doubtful Accounts had no previous balance.

- Now let's assume that this is not Epson's first year, but rather a later year. Also, assume the Allowance account has a $200 credit balance prior to adjustment.

- Since the $200 credit balance is already in the account, we need an adjustment for the difference, $2,742 – $200 = $2,542. Epson Supply would prepare the following entry.

Dec. 31	Bad Debts Expense	2,542	
	Allowance for Doubtful Accounts		2,542

Determining the Adjusting Entry When the Allowance for Doubtful Accounts Account Has a Previous Balance

- Now, let's assume the Allowance account has a $300 debit balance prior to adjustment.
- A debit balance results when the actual accounts written off during the period exceed the amount estimated.
- In this case, it becomes necessary to adjust for more than the estimate from the aging schedule, because our goal is still to end up with a credit balance of $2,742.
- We thus add the $300 debit balance to the desired credit balance of $2,742 and make an adjusting entry for $3,042, as follows:

Dec. 31	**Bad Debts Expense**	**3,042**	
	Allowance for Doubtful Accounts		**3,042**

Summing Up

- Under the allowance method, you are **estimating** the amount of bad debts for the **coming** accounting period.
- The Allowance for Doubtful Accounts account is
  - A contra asset account — Accounts Receivable
- Under the allowance method, a customer's account is always written off by
  - ✓ Debiting the *Allowance for Doubtful Accounts* account
  - ✓ Crediting *Accounts Receivable* and the customer's subsidiary ledger accounts

Recording the Recovery of Accounts Under the Allowance Method

- Assume Hunt Company prepared the following entry to write off Jim Pearson's account on Nov. 4, 20X1.

20X1 Nov. 4	Allowance for Doubtful Accounts	500	
	Accounts Receivable-Jim Pearson		500

- On Apr. 20, 20X2, Pearson is able to make full payment on his account. Hunt Company prepares the following entries:

20X2 Apr. 20	Accounts Receivable-Jim Pearson	500	
	Allowance for Doubtful Accounts		500

20X2 Apr. 20	Cash	500	
	Accounts Receivable-Jim Pearson		500

Two Approaches for Estimating Bad Debts Using the Allowance Method

Income Statement Approach

Also called the percentage of sales method.

The estimate is based on a percentage of the credit sales for the year.

Balance Sheet Approach

Also called the percent of receivables approach.

The estimate is based on an aging of the accounts receivable at the end of the year.

Two Approaches for Estimating Bad Debts Using the Allowance Method

Income Statement Approach

Adjusting Entry:

Debit: Bad Debts Expense

Credit: Allowance for Doubtful Accounts

An existing balance in the Allowance for Doubtful Accounts account does **not** have to be considered when making the adjustment.

Balance Sheet Approach

Adjusting Entry:

Debit: Bad Debts Expense

Credit: Allowance for Doubtful Accounts

An existing balance in the Allowance for Doubtful Accounts account **does** have to be considered when making the adjustment.