Bad Debts and Doubtful Debts

Editorial

This month we feature a topic that often causes students some difficulty, that of Bad Debts and a provision for Doubtful Debts.

The writing off procedure for a bad debt is often handled competently by students in an examination environment but raising an initial provision for bad debts and its subsequent revision in the form of an increase or decrease can be difficult to deal with.

This paper therefore should be of particular interest to our registered students preparing for both the manual and computerised tests of competence together with serving as a refresher for those of you as members in practice that need to deal with the practical application of this interesting concept. If you are waiting for the results of the October examinations, I do so hope that your journey was successful.

Dr Philip E Dunn
Editor
Head of Education

Trainee Certified Bookkeepers need to develop competence in the procedure for writing off a bad debt and also dealing with the creation of a provision for doubtful debts together with its review on an annual basis.

As an examiner I find this an area that often causes difficulty, however if you master the principles any examination question on the topic will be easily understood.

This short paper will I am sure be of interest not only to our student audience but as a refresher to those of you in practice that may be required to deal with this concept.

In most businesses debtor balances represent an important element of working capital. Accounting principles dictate that the supply of goods or services is accounted for as sales, at the point at which the buyer has a legal obligation to pay for them. Total debtors represent the value of credit sales for which payment has yet to be received.

An obligation and certainly of payment differ, as payment for a variety of reasons is not always forthcoming. The customer may have become insolvent or is experiencing cash flow problems.

Accounting concepts that underpin the fundamental principles including that of ‘prudence’ apply here.

Prudence is a concept covered in the former standard SSAP2, Disclosure of Accounting Policies and is still prominent in the standard FRS 18, Accounting Policies.

It is clear that having taken credit for the sale, accountants should write back as soon as identified any ‘bad debts’ and make provision for those unlikely to be paid.

The analysis of aged debtors’ lists and scrutiny of those outstanding beyond a reasonable time will help in identifying likely doubtful debts. Research suggests that average debtor days in the UK are around 67, and there is still much room for improvement.

The difference between the procedures for dealing with specific bad debts and a provision for doubtful debts includes:

A bad debt arises when there is ‘no hope’ of receiving payment from the customer. The amount is written out of the debtor’s account in the sales ledger and written off as a charge against profits. Whereas a provision for doubtful debts, also complying with the principles of FRS 18, recognises the extent of the risk being taken by entering into credit sale transactions. The provision is an estimate of the possible liability that may arise rather than that of a certain nature.

The initial provision is a charge against the profit and loss account but is then carried forward to a subsequent period. The debtors figure in the balance sheet is adjusted to ‘net of the provision’. This gives ‘a more true and fair view' of the debtors at that point in time. Any increase or decrease in the provision in a subsequent period is debited or credited to the profit and loss account.

The case study that follows illustrate these procedures.

- **Bad Debts**

Dunn and Musgrave are practising accounting technicians and invoiced the Crescent Hotel on 31 December 2003 for supply of services, £600 + VAT. They maintain a general ledger including control accounts.

On 1 July 2004 the account was still outstanding and it becomes clear that the proprietor of Crescent Hotel is in serious financial difficulty and they decide to write off the debt.

As the debt is now over six months old they can claim bad debt relief relating to VAT.

The Journal entry required to write off the bad debt would show:

Journal Entry			
Date	**Detail**	**DR**	**CR**
1 July	Bad debts a/c VAT a/c Sales Ledger Control Account Being the write off of a bed debt and claim for bad debt relief	600.00 105.00	705.00

This is the write off of a specific bad debt.

The balance on the bad debts account at the end of the financial year would be transferred ie: charged to the profit and loss account.

- **Provision for doubtful debts**

At 31 December 2004, their financial year end Dunn and Musgrave had a balance on their Sales Ledger Control Account of £9500 and they decide to create a provision for doubtful debts of 5% of debtors.

The Journal entry for this would show:

Journal Entry			
Date	**Detail**	**DR**	**CR**
31 Dec	Profit and loss a/c Provision for doubtful debts account	475.00	475.00

An extract from the profit and loss account for year ended 31 December 2004 would show:

	£
Bad Debts written off	600
Provision for doubtful debts	475

And; on the balance sheet

Current Assets

Debtors	9500.00	
Less provision for doubtful debts	475.00	
		9025.00

The provision would remain in the books as a credit balance on the provision for doubtful debts account until it is revised.

On the 31 December 2005 the balance on the Sales Ledger Control Account was £12100 and they decide to maintain the provision for doubtful debts at 5% of debtors.

Here we need to compare the existing provision with the revised or up-dated provision:

	£	
Exsiting provision	475	
Up-dated provision	605	(5%*£12100)
Increase in the provision	£130	

This increase would be debited to the profit and loss account.

The provision for doubtful debts account at the start of the financial year shows:

Provision for Doubtful Debts

			2005		
			1 Jan	Balance B/D	475

A Journal entry would then be raised as:

Journal Entry			
Date	**Detail**	**DR**	**CR**
31 Dec	Profit and loss a/c Provision for bad and doubtful debts	130.00	130.00

Being an increase in the provision for bad and doubtful debts.

The provision account would then show:

Provision for Bad and Doubtful Debts

			2005		
31 Dec	Balance C/D (2)	605.00	1 Jan	Balance B/D (1)	475.00
			31 Dec	Profit and loss a/c (3)	130.00
		£605.00			£605.00
			2006		
			1 Jan	Balance B/D (2)	605.00

(1) is the opening provision
(2) is the new provision and the balance is brought down on the credit side of the account in January 2006
(3) the difference ie: increase provision is debited to profit and loss a/c

The profit and loss account would be charged ie: debited with the increase in the provision and the debtors figure on the Balance Sheet would comprise £11495 ie: (£12100 - £605).

Likewise if a decrease in the provision arises this would be credited to the profit and loss account and the revised ie: decreased total provision would be deducted from the total debtors for the Balance Sheet purposes.

An Extract from the profit and loss account for year ended 31 December 2005 would show:

Increase in Provision for Bad Debts. £130.

An Extract from the Balance Sheet as at 31 December 2005 would show:

Current Assets:	
Debtors	£12100
Less Provision for Bad Debts	605
	£11495