

Bad debts

Often accountants have a problem with the figure for the Debtors account.

The Debtors account reflect the amount of money owed to the business by clients/debtors.

In practice it may be very difficult to collect the amount owed by debtors.

A business can take legal action against a defaulting debtor, but legal action may be costly and funds may not be recovered if a client is insolvent or has disappeared.

After doing all legal procedures to collect the owed amount the business may decide that it is not worth it to continue chasing the debtor for payment.

An entry will be made in the General Journal:

Dr **Bad debts** (an **expense** in the Nominal section) → Owner's equity decreases

Cr Debtors control (an **asset** in the Balance sheet section) → Assets decrease

At the same time, the debtor's personal account in the Debtors Ledger will also be credited.

Bad debts recovered

Despite writing off a debtor's account, a business will continue to chase the debtor for payment. If the debtor pays some time in the future, the following entry will be made in the CRJ:

Dr Bank → Assets increase

Cr **Bad debts recovered** (an **income** in the Nominal section) → Owner's equity increases

Provision for bad debts

furthermore, even if bad debts are all written off, there might be debtors still who may not pay in the future. The accountant may not be able to identify them. He may want to record items on a pessimistic (negative) or conservative basis in order to comply with the GAAP concept of prudence. The accountant will make an entry to provide for the debtors who might well prove to be bad in the future. An entry will be made in the General Journal:

Dr **Provision for bad debts adjustment** (an expense in the Nominal section) → Owner's equity decreases

Cr **Provision for bad debts** (an account with a credit balance in the Balance sheet section - **negative asset**) → Assets decrease

WHEN PREPARING THE FINANCIAL STATEMENTS, THIS CREDIT BALANCE WILL BE SUBTRACTED FROM DEBTORS TO REDUCE THE AMOUNT SHOWN FOR THIS ASSET.

For example 1: Provision for bad debts - creating an account

Cunningham Traders started trading on 1 Mar 2016, and their first financial year therefore ends on 28 February 2017.

Extract from Pre-adjustment Trial Balance of Cunningham Traders as at 28 Feb 2017

Balance Sheet account	Fol.	Debit	Credit
Debtors control	B8	16 000	

Provision for bad debts must be adjusted to 5% of outstanding debtors on 28 Feb 2017.

Calculation → R16 000 X 5% = R800

General Journal of Cunningham Traders for Feb 2017

Day	Details	Fol.	Debit	Credit
28	Provision for bad debts adjustment	N7	800	
	Provision for bad debts			800

General Ledger of Cunningham Traders
Balance Sheet accounts section

Provision for bad debts

Date	Details	Fol.	Amount	Date	Details	Fol.	Amount
				2017 Feb	28 Provision for bad debts adjustment	GJ	800

Nominal account section
Provision for bad debts adjustment

Date	Details	Fol.	Amount	Date	Details	Fol.	Amount
2017 Feb	28 Provision for bad debts	GJ	800	2017 Feb	28 Profit & loss	GJ	800

How this affects the accounting equation?

Assets	Owner's equity	Liabilities
-800 Provision for bad debts increased (negative asset)	-800 Provision for bad debts adjustment is an expense	0

This balance does not necessarily increase every year. Judging from past history of debtors, a business could determine approximately what percentage of its debtors is likely to bad. If debtors increase the following year, then the provision for bad debts will increase. If debtors decrease the following year, then the provision for bad debts will decrease. Also business might improve its collection procedures, and might decide to decrease the relevant percentage to take into account the current conditions. An entry will be made in the General Journal:

Increase in provision for bad debts:

Dr Provision for bad debt adjustment (with difference for the current year - an expense in the Nominal section) → Owner's equity decreases

Cr Provision for bad debts (increase this credit balance in the Balance sheet with the difference for the current year) → Assets decrease

For example 2: Provision for bad debts - as an expense

The financial year of Cunningham Traders ends in Feb. The business has already been trading for 2 years.

Extract from Pre-adjustment Trial Balance of Cunningham Traders as at 28 Feb 2018

Balance Sheet account	Fol.	Debit	Credit
Debtors control	B8	17 200	
Provision for bad debts			800

Provision for bad debts must be adjusted to 5% of outstanding debtors on 28 Feb 2018.

Calculation → R17 200 X 5% = R860
 Therefore, R860 - R800 = R60 adjustment

General Journal of Cunningham Traders for Feb 2018

Day	Details	Fol.	Debit	Credit
28	Provision for bad debts adjustment	N7	60	
	Provision for bad debts			60

General Ledger of Cunningham Traders
 Balance Sheet accounts section

Provision for bad debts

Date	Details	Fol.	Amount	Date	Details	Fol.	Amount
				2017 Mar	1 Balance	b/d	800
				2018 Feb	28 Provision for bad debts adjustment	GJ	60

Nominal account section
 Provision for bad debts adjustment

Date	Details	Fol.	Amount	Date	Details	Fol.	Amount
2018 Feb	28 Provision for bad debts	GJ	60	2018 Feb	28 Profit & loss	GJ	60

How this affects the accounting equation?

Assets	Owner's equity	Liabilities
-60 Provision for bad debts increased (negative asset)	-60 Provision for bad debts adjustment is an expense	0

Increase in provision for bad debts:

Dr Provision for bad debts (decrease this credit balance in the Balance sheet with the difference for the current year) → Assets increase

Cr Provision for bad debt adjustment (with difference for the current year - an income in the Nominal section) → Owner's equity increases

For example 3: Provision for bad debts - as income

The financial year of Cunningham Traders ends in Feb. The business has already been trading for 3 years.

Extract from Pre-adjustment Trial Balance of Cunningham Traders as at 28 Feb 2019

Balance Sheet account	Fol.	Debit	Credit
Debtors control	B8	14 300	
Provision for bad debts			860

Provision for bad debts must be adjusted to 5% of outstanding debtors on 28 Feb 2019.

Calculation → R14 300 X 5% = R715

Therefore, R715 - R860 = -R145 adjustment (**ignore the minus sign**)

General Journal of Cunningham Traders for Feb 2019

Day	Details	Fol.	Debit	Credit
2	Provision for bad debts	N7	145	
	Provision for bad debts adjustment			145

General Ledger of Cunningham Traders
Balance Sheet accounts section

Provision for bad debts

Date	Details	Fol.	Amount	Date	Details	Fol.	Amount
2019 Feb	28 Provision for bad debts	GJ	145	2018 Mar	1 Balance	b/d	860
	Balance	c/d	715				
			860				860
				2019 Mar	1 Balance	b/d	715

Nominal account section
Provision for bad debts adjustment

Date		Details	Fol.	Amount	Date		Details	Fol.	Amount
2019 Feb	28	Profit & loss	GJ	145	2019 Feb	28	Provision for bad debts	GJ	145

How this affects the accounting equation?

Assets	Owner's equity	Liabilities
+145 Provision for bad debts decreased (negative asset)	+145 Provision for bad debts adjustment is an income	0

Do
Task 5.19; 5.20