Provision for Bad Debts

Provisions for bad debts

When we are drawing up our final accounts we want to show in the balance sheet as correct a figure as possible of the true value of debtors at a certain date. In **ADDITION** to bad debts that are charged as a definite expense, a *provision for bad debts* account is opened.

In a similar way to the provision for depreciation, the provision for bad debts is an estimate by accountants as to the amount of debtors that are ***UNLIKELY*** to pay their debts. This provision is charged as an expense but the money never actually leaves the business. By providing for debtors that are unlikely to pay off their debts the accountant helps to adhere to the accounting concept of relevance by showing a truer value of debtors in the Balance Sheet.

So in order to overcome the problem of charging against profits for bad debts and the provision for bad debts two separate accounts are opened up:

One) **Bad debts expense account** → This is used only when the debt has been proved to be a definite bad debt and is written off.

Two) **Provision for bad debts account** → This account is used only for estimates of the amount of the debtors at the year end that are likely to finish up as a bad debt.

To try to get an accurate figure as possible for the provision, the firm will make the best estimate it can of the number of debtors that are unlikely to pay their debts using one of two methods:

1- *Experience* → The firm will know from experience that a certain percentage of debtors are unlikely to pay off their debts.

2- *Individual Accounts* → The firm will look at each debtor account in the Sales Ledger at the end of the financial year and will estimate a percentage based upon an opinion on which debtors are unlikely to pay.

Accounting entries for provisions for bad debts

As the account is a provision then the entry is made directly from the credit side to the debit side of the Profit & Loss Account.

Example

At 31st December 19X8 the debtors figure amounted to $10,000. It is estimated that 2 per cent of debts (i.e. $200) will prove to be bad debts, and it is decided to make a provision for these. The accounts would appear as follows:

Provision for bad debts (20X8)

Dr		$			Cr $
31.12.X8	Bal. c/d	200	31.12.X8	Profit & Loss	200
		200			**200**
			1.1.X9	Bal. b/d	200

Trading and Profit and Loss Account for the year ended the 31.12.X8

Dr	$		Cr $
Opening Stock	XXX	Sales	XXX
		Closing Stock	XXX
Gross Profit bal. c/d	XXX		XXX
Wages	XXX	Gross Profit bal. b/d	XXX
Lighting and heating	XXX		
Provision for Depreciation	XXX		
Rent	XXX		
Bad Debts	90		
Provision for bad debts	**200**		
General expenses	XXX		
Carriage inwards	XXX		
Net Profit bal. c/d	XXX		
	XXX		**XXX**
Capital	XXX	Net Profit bal. b/d	XXX

Balance Sheet (extract) as at 31st December 20X8

	$	$	$
Current Assets			
Debtors	10,000		
Less Provision for bad debts	200		
	9,800		

The deduction of the provision for bad debts gives a more accurate figure for the value of the current asset of debtors thereby fulfilling the accounting rule of *relevance*

Increasing the provision for bad debts

When increasing the provision from one year to the next then there will already be a balance brought down from the previous year's Trading and Profit & Loss account. This provision will never have actually left the business and as a result only the difference in the increase will need to be deducted as an expense from the firm's profit and loss account at the end of the financial year.

Example

Let us suppose that for the same firm as in the previous example, the provision for bad debts will need to be increased for the year ended the 31st of December 20X9. This was because the provision was kept at 2 per cent, but the debtors had risen to $12,000. A provision of $200 had been brought down for the previous year, but we know want a total of $240 (i.e. 2 per cent of $12,000). All that is needed is a provision for an extra $40 to be debited as an expense from the Profit & Loss Account. The $40 added to the $200 will make up the provision for bad debts needed of $240.

Dr **Provision for bad debts (19X8)** Cr

		$			$
31.12.X8	Bal. c/d	200	31.12.X8	Profit & Loss	200
		200			**200**
			1.1.X9	Bal. b/d	200
31.12.X9	Bal. c/d	240	31.12.X9	Profit & Loss	40
		240			**240**
			1.1.X0	Bal. b/d	240

Dr **Trading and Profit and Loss Account for the year ended the 31.12.X9** Cr

	$		$
Opening Stock	XXX	Sales	XXX
		Closing Stock	XXX
Gross Profit bal. c/d	XXX		XXX
Wages	XXX	Gross Profit bal. b/d	XXX
Lighting and heating	XXX		
Provision for Depreciation	XXX		
Rent	XXX		
Bad Debts	XXX		
Provision for bad debts	**240**		
General expenses	XXX		
Carriage inwards	XXX		
Net Profit bal. c/d	XXX		
	XXX		**XXX**
Capital	XXX	Net Profit bal. b/d	XXX

Balance Sheet (extract) as at 31st December 20X9

Current Assets	$	$	$
Debtors	12,000		
Less Provision for bad debts	240		
	11,760		

Decreasing the provision for bad debts

The balance brought down from the previous year is shown on the credit side of the provision for bad debts account. In order to reduce this amount then a debit entry is made in the provision for bad debts account and this adds to the income of the Profit and Loss Account at the end of the financial year.

Example
Remaining with the same company, the firm's overall debtors drops to $10,500 for the financial year ended the 31st of December 20X0. If the provision remained at 2 per cent then estimated debtors unlikely to pay would drop to $210. As the balance brought down was $240 from the year 20X9 then a reduction of $30 needs to be made:

Dr **Provision for bad debts (19X8)** Cr

		$			$
31.12.X8	Bal. c/d	200	31.12.X8	Profit & Loss	200
		200			**200**
			1.1.X9	Bal. b/d	200
31.12.X9	Bal. c/d	240	31.12.X9	Profit & Loss	40
		240			**240**
31.12.X0	Profit & Loss	30	1.1.X0	Bal. b/d	240
31.12.X0	Bal. c/d	210			
		240			**240**
			1.1.X1	Bal. b/d	210

Dr **Trading and Profit and Loss Account for the year ended the 31.12.X0** Cr

	$		$
Opening Stock	XXX	Sales	XXX
		Closing Stock	XXX
Gross Profit bal. c/d	XXX		XXX
Wages	XXX	Gross Profit bal. b/d	XXX
Lighting and heating	XXX	**Reduction in the provision for bad debts**	**30**
Provision for Depreciation	XXX		
Rent	XXX		
Bad Debts	XXX		
General expenses	XXX		
Carriage inwards	XXX		
Net Profit bal. c/d	XXX		
	XXX		**XXX**
Capital	XXX	Net Profit bal. b/d	XXX

Balance Sheet (extract) as at 31st December 20X0

Current Assets	$	$	$
Debtors	10,500		
Less Provision for bad debts	210		
	10,290