

# THEME: BAD DEBTS

By John W. Day, MBA

## **ACCOUNTING TERM: Bad Debt**

Bad debt, in an accounting environment, represents revenue from sales that were purchased on credit and/or notes receivable that have proven uncollectible.

## **FEATURE ARTICLE: Recording Bad Debt: Accrual and Cash**

If you offer credit to customers or loan money for business purposes you run the risk of not being able to collect all or part of it. It's just a fact of life. You might wonder why anyone would offer credit if there is a chance of not getting paid. The reason is that by offering credit there is a greater opportunity to acquire more sales. The increased sales should more than offset any bad debts.

Bad debts can be attributed to more than just a few flaky customers. They can be a result of a poorly managed accounts receivable collection system. Therefore, a business needs to make sure a good system is in place before offering credit. It is very disheartening to work hard for nothing. Depending on whether a business operates on a "cash basis" or an "accrual basis" dictates how the accounting for bad debts is handled and whether a tax deduction can be taken. If an accrual basis is being used then the accounting is set up like this:

When a credit sale is generated there is an increase (debit) to Accounts Receivable (an asset account) and a corresponding increase (credit) to a Sales (a revenue account). For example:

DESCRIPTION	DEBIT	CREDIT
Accounts Receivable	10,000	
Sales		10,000

In this case, it has been estimated that based on a few years of past history, an average of five percent of all credit sales have proven worthless. Five percent of \$10,000 is \$500. Therefore, a contra-account is needed to offset the accounts receivable account. In accrual accounting this account is called "Allowance for Doubtful Accounts" or "Reserve for Doubtful Accounts". It is usually located next to the accounts receivable account so one can see how much is expected to not be collected.

DESCRIPTION	DEBIT	CREDIT
Bad Debt Expense	500	
Allow Doubtful Accts		500

You can see that Allowance for Doubtful Accounts is set up as a credit balance (\$500) which then offsets the Accounts Receivable debit balance (\$10,000). The net balance of accounts receivable is then \$9,500.

The purpose of doing this is to give a more accurate picture of the assets on the balance sheet and follows the principle of “conservatism” by not overstating the value of the assets.

At the end of the year, when the books are closed and the actual amount of bad debts is determined, an adjusting entry is required. If the results are that only \$400 was proven to be uncollectible then a \$100 general journal entry must be made. For instance:

DESCRIPTION	DEBIT	CREDIT
Allow Doubtful Accts	100	
Bad Debt Expense		100

Now the books are accurate. But, what if later on some of those accounts that were construed to be bad debts and written off turned out to be good? In other words, the customer finally got around to paying. It is simple enough. The amount paid is treated as a sale and recorded to “Other Income” or “Doubtful Accounts Recovered”.

DESCRIPTION	DEBIT	CREDIT
Cash	75	
Other Income		75

Keep in mind that the reason an expense deduction is allowed is because it is offsetting revenue that was previously recorded. Had that not happened which is the case in a “cash basis” operation, no deduction is allowed.

In a cash basis system, a sale only occurs if cash is received. If it is received there is no bad debt. That makes sense doesn't it? But what if you received a bad check from someone and had already recorded it as a cash sale? Instead of recording it as a “Bad Debt” on the expense section of the income statement (a debit) record it as a debit to the sales account. In actuality, the sale never happened so a debit to sales decreases the previous increase. This way avoids showing a bad debt expense account on a cash basis statement which is considered incongruous.

Sometimes a cash basis business will use a hybrid system and maintain an accounts receivable system on the books. In this case, one still does not record an increase in revenue when a credit sale takes place. Instead, a “deferred income” account is used. For example:

DESCRIPTION	DEBIT	CREDIT
Accounts Receivable	10,000	
Deferred Income		10,000

Deferred Income is a liability account. It offsets the Accounts Receivable asset account so that no credit activity reaches the income statement. When a customer makes a payment then two journal entries are required:

DESCRIPTION	DEBIT	CREDIT
Cash	1,000	
Sales		1,000

DESCRIPTION	DEBIT	CREDIT
Deferred Income	1,000	
Accounts Receivable		1,000

If a bad debt occurs only one journal entry is required.

DESCRIPTION	DEBIT	CREDIT
Deferred Income	100	
Accounts Receivable		100

Remember, In a cash basis system there is no bad debt expense from accounts receivable activity.

An important note to remember is that if inventory is involved in the sale, the cost of that inventory (Cost of Goods Sold) can be deducted. This is because the customer walked away with the inventory even though it was never paid for. That is a true business cost and therefore a legitimate business expense.

Sometimes an owner of a service business thinks that the time it took to provide the service should be able to be written off as a bad debt when the client or customer reneges on the payment. However, unless that time was recorded on the books as revenue, there is no expense deduction allowed. This may seem unfair but think about it like this: Bad debt expense is used to offset revenue that has been recorded but will never be realized monetarily. In a cash-basis service business the revenue for the services rendered have not be recorded so there is nothing to offset. The bottom line reflects no additional profit so there is no need for a bad debt expense.

That's nice, but you say your time is valuable and you lost that value, therefore, you should be able to receive a deduction. The problem is that there is no measurable economic substance that was lost. Your hourly rate is arbitrary. If this were allowed, it would open a "Pandora's Box" whereby any amount imagined could be construed as a deductible expense. It's too subjective and ripe for abuse so the lid to Pandora's Box is kept closed.

### **QUESTION: How Are Bad Debts Recorded For A Notes Receivable?**

Occasionally, a company might make a loan to a supplier, client, or some other business related person. When that happens it is recorded like this:

DESCRIPTION	DEBIT	CREDIT
Notes Receivable	5,000	
Cash		5,000

If that note goes sour then the following journal entry would be required, regardless whether a cash or accrual system is used:

DESCRIPTION	DEBIT	CREDIT
Bad Debt Expense	5,000	
Notes Receivable		5,000

Another scenario is when a company has to pay the debts of an insolvent partner. Or, if a company, for a reasonable business consideration, guaranteed a loan and has to make good on it. In these cases, the journal entry should be written as follows:

DESCRIPTION	DEBIT	CREDIT
Bad Debt Expense	5,000	
Cash		5,000

Bad debt expense is usually recorded in the year in which the debt was deemed to be totally worthless. However, if the debt is partially worthless the worthless part can be written off in the year it becomes worthless. Or, if desired, it is possible to wait and record the entire bad debt in the year it becomes “totally” worthless.

How does one know when a debt is “totally” worthless? The best evidence is a court notice that the debtor has declared bankruptcy. Second to that will be letters of collection and records of phone calls over a reasonable period of time showing a good faith effort to collect. Don’t be too cavalier about declaring a bad debt because you may have to show evidence that it is uncollectible.

Anytime actual funds are loaned to another party a formal note should drawn up that states the date the loan was originated, the length of time during which the loan will be repaid, and the rate of interest to be charged. It is always best, if possible, to obtain collateral in case of default.

### **TIP: Three Methods of Determining Bad Debts**

The first two are methods of “estimating” bad debts:

(1) The income statement approach - The average percentage of credit sales not collected in past accounting periods is a logical basis for estimating the portion of current credit sales that will prove uncollectible. It is simple to apply and makes possible an estimate of doubtful accounts expense as soon as credit sales are recorded. It conforms to the matching principle of costs to revenue. It can be refined even further by analyses of the experience for different classes of customers or in different geographical locations. When the actual collection experience is in, then an adjustment of the estimate can be made for accuracy.

(2) The balance sheet approach – This estimate is derived by analyzing accounts receivable accounts by age group (how long they have been outstanding) and probability of collection. Generally, a significant correlation exists between the length of time an account is past due and its collectibility. A summary report known as an “aging of accounts receivable” is generated that keeps track of how old the accounts are. Usually 30, 60, 90, or 120 days or more are the categories. Each category can be studied to determine the percent of accounts that are normally uncollectible. These percentages are applied to the latest aging report to arrive at the estimate.

The third method does not estimate bad debts. It measures “actual” bad debt.

(3) Direct write-off method or specific charge-off method – With this method the bad debt is recognized only after the accounts become worthless. In fact, you should be aware that under U.S. tax law, you have to use this method to deduct bad debt expense. The problem with this approach from a purely accounting standpoint is that it does not properly match bad debt expense with revenue as required in accrual basis accounting. This is because it overstates the net realizable value of the receivables. An accounts receivable sale in year 1 may be written off in year two, and an accounts receivable representing a sale in year 2 may be written off in year 3 or 4.

For accounts receivable, notes receivable, or any other business transaction that triggers the need for a bad debt expense deduction, there must be a true creditor-debtor relationship. It can't be a personal loan to a family member or friend. In addition, there should be a legal obligation to pay a fixed sum of money. If the money isn't paid there has to be a realized loss. This means there has to be an actual loss of money not just your time, as I said before.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at <http://www.reallifeaccounting.com> to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.