Bookkeeping Tips

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Recording Bad Debt Expense For Tax v. Book Purposes

For tax purposes: The direct write-off method. Under the direct write-off method, which is required by the IRS for income tax purposes, bad debt expense is taken when the company determines that an accounts receivable cannot be collected. (This method *cannot* be used for book purposes under generally accepted accounting principles.) Very small companies sometimes use this method for both tax and book purposes.

For book purposes: The allowance method. Under this method, which is required by GAAP, there are two ways to estimate bad debt expense**:**

1. As a percentage of credit sales. Under the percentage of credit sales method, at year end, management estimates the percentage of credit sales that it may not collect. This estimate is recorded as follows:

Bad Debt Expense
    Allowance For Doubtful Accounts

Example 1: Bad debt as a percentage of credit sales. For 20X5, SimCo has credit sales of $200,000. Based on past experience, the company estimates that bad debt loss for the year will be 2% of credit sales. SimCo records its bad debt loss for book purposes (as opposed to tax purposes) for the year as follows:

Bad Debt Expense	4,000	
Allowance For Doubtful Accounts		4,000

To record bad debt expense

At the end of each year (or other period), SimCo will record its estimate of bad debt with a debit to Bad Debt Expense and a credit to Allowance For Doubtful Accounts.

2. As a percentage of accounts receivable. This estimate is based on aging receivables (those receivables far enough past due that management now considers payment doubtful). Whatever the dollar amount, it must become the ending balance in the Allowance For Doubtful Accounts. Thus, recording bad debt expense under the percentage of accounts receivable method requires the following steps:

A. Find out from management what dollar amount of total receivables it does not expect to collect. *This amount must become the ending balance in the Allowance For Doubtful Accounts.*

B. Check the current balance in the Allowance For Doubtful Accounts to see how much it must be either increased or decreased to arrive at the required ending balance. The journal entry that you record for bad debt expense must give you the required ending balance in the Allowance For Doubtful Accounts.

Example 2: There is a credit balance in Allowance For Doubtful Accounts. At year-end 20X6, DruCo has accounts receivable of $90,000 and estimates that bad debt will be 5% of these accounts receivable. Thus, bad debt for the year is estimated at $4,500 ($90,000 x 5%). DruCo's Allowance For Doubtful Accounts has a current credit balance of $3,000. Therefore, DruCo must increase the balance by $1,500 to arrive at the required ending balance of $4,500 ($3,000 current balance + $1,500 increase = $4,500 ending balance) as follows:

(continued)

Bad Debt Expense	1,500	
Allowance For Doubtful Accounts		1,500
To record bad debt expense		

This is a fairly typical year-end adjustment. But, as explained earlier, when more accounts receivable are written off during the year than management estimated, the Allowance For Doubtful Accounts may end up with a debit balance.

Example 3: There is a debit balance in Allowance For Doubtful Accounts. During 20X7, DruCo discovers that it significantly underestimated its bad debt. By year end, the Allowance For Doubtful Accounts has a *debit* balance of $2,000. At year-end 20X7, DruCo has accounts receivable of $45,000 and estimates that bad debt will be 10% of accounts receivable, or $4,500 ($45,000 x 10%).

Because the Allowance For Doubtful Accounts currently has a *debit* balance of $2,000, DruCo must add this $2,000 to the desired ending balance of $4,500 to determine the amount of the credit to the Allowance For Doubtful Accounts ($2,000 debit + $4,500 desired ending balance = *$6,500 credit* to the account) as follows:

Bad Debt Expense	6,500	
Allowance For Doubtful Accounts		6,500
To record bad debt expense		

This entry can be illustrated with a T-account:

Allowance For Doubtful Accounts

		3,000	**1/1/X7**[1]
4/5	1,750		
6/17	750		
8/2	1,000		
9/25	300		
11/5	1,200		
12/31/X7	2,000[2]		
		6,500	**AJE on 12/31/X7**[3]
		4,500	Ending balance

1. This is the same as the 20X6 ending balance.

2. $3,000 opening credit balance – $5,000 debit balance from accounts actually written off during the year = $2,000 debit balance on 12/31/X7 before the AJE is made. Management estimated that bad debt would be $2,000 for 20X7, but ended up writing off $4,000 in bad debt during the year, leaving a *debit* balance of $2,000 before the final adjustment was made.

3. To produce the correct ending balance of $4,500 in the account required a credit of $6,500.

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The American Institute of Professional Bookkeepers (AIPB), is the national association for bookkeepers, currently with 30,000 active members

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AIPB was founded in 1987 for the following purposes:

- To recognize bookkeeping as a profession—and bookkeepers as professionals
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- To answer members' everyday bookkeeping and accounting questions on the telephone at no charge.
- To provide bookkeepers with low-cost continuing professional education.
- To return the membership fees of any bookkeeper who is dissatisfied with the benefits of membership