Bad and Doubtful Debts

A complete last-minute revision map: good vs doubtful vs bad debts, specific & general allowances, write-offs, and recoveries — exactly as tested in PRC-1.

Good / Doubtful / Bad | Specific & General Allowance | Write-Off Journal Entries | Recovery of Bad Debts

1 CORE CONCEPT

> *Prudence requires a business to recognise the risk that some receivables will not be collected — either by writing off debts that are certainly irrecoverable, or by creating an allowance for debts that are only doubtful.*

GOOD DEBT
Full collection expected with certainty (e.g. secured, or backed by a guarantee). No special treatment needed.

DOUBTFUL DEBT
Collection is uncertain, but not impossible. An **allowance** is created — the receivable is NOT removed from the books.

BAD DEBT
Definitely irrecoverable. The receivable is **written off** completely from the books.

2 KEY DEFINITIONS

Allowance for Doubtful Debts
A provision that reduces receivables in the SOFP, without removing the individual balances from the ledger.

Specific Allowance
An allowance calculated against a particular, identified customer balance.

General Allowance
A percentage applied to the remaining receivables balance, after specific items are excluded.

3 IMPORTANT ACCOUNTING RULES — BUILDING THE ALLOWANCE

✓ Order of Calculation

Step 1 — Write off confirmed bad debts
Remove definitely irrecoverable balances first

Step 2 — Calculate specific allowance
Apply the required % to identified doubtful balances

Step 3 — Calculate general allowance
Apply the general % to the REMAINING receivables

✗ Excluded from General Allowance Base

Debts already written off
No longer part of receivables

Debts covered by a specific allowance
Already individually assessed

Debts secured / fully recoverable
Good debts carry no doubt

4 FORMULAS

GENERAL ALLOWANCE

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General Allowance =
(Receivables − Written Off − Specific Items) × General %
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DOUBTFUL DEBTS EXPENSE FOR THE YEAR

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Expense = Required Closing Allowance − Opening Allowance
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A decrease in the required allowance is recognised as income, not an expense.

5 ACCOUNTING TREATMENT — DR / CR FORMATS

WRITE OFF A BAD DEBT

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Dr  Bad Debts Expense
   Cr  Receivables
```

INCREASE THE ALLOWANCE

```
Dr  Doubtful Debts Expense
   Cr  Allowance for Doubtful Debts
```

DECREASE THE ALLOWANCE

```
Dr  Allowance for Doubtful Debts
   Cr  Doubtful Debts Expense (income)
```

6 STEP-BY-STEP ROADMAP — CALCULATING THE EXPENSE

1. **Write off confirmed bad debts**
   Deduct from receivables; if already covered by allowance, reduce the allowance first.
2. **Calculate the required closing allowance**
   Specific allowance + general allowance on the remaining base.
3. **Compare to the opening allowance**
   (after adjusting for any write-off already absorbed).
4. **The difference is the expense (or income)**
   Top-up needed = expense. Excess release = income.

7 JOURNAL ENTRIES — RECOVERY OF A WRITTEN-OFF DEBT

CASH RECEIVED FOR A DEBT PREVIOUSLY WRITTEN OFF

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Dr  Cash / Bank
   Cr  Bad Debts Recovered (income)
```

Only the amount **actually received** is recognised as income — not the full original written-off balance.

8 LEDGER TREATMENT — ALLOWANCE FOR DOUBTFUL DEBTS

ALLOWANCE FOR DOUBTFUL DEBTS	
DEBIT (Dr)	**CREDIT (Cr)**
Write-off of a debt already covered by the allowance; decrease in the required allowance	Balance b/d (opening allowance); increase in the required allowance (expense)

9 FINANCIAL STATEMENT EFFECT

↓ **Bad debts expense / increased allowance**
Both reduce profit in the income statement

= **Allowance for doubtful debts**
A contra-asset — deducted from receivables in the SOFP

↑ **Bad debts recovered**
Recognised as income — increases profit

SOFP presentation: **Receivables − Allowance for Doubtful Debts = Net Receivables.**

10 COMMON EXAM CASES — DECISION TREE

IF collection is certain	→ Good debt — no allowance needed
IF only uncertain	→ Doubtful — create/adjust the allowance
IF definitely irrecoverable	→ Bad — write off fully from receivables
IF write-off already provided for	→ Reduce allowance first, then top up to required
IF cash later recovered	→ Recognise only the amount received as income

11 COMMON MISTAKES / EXAM TRAPS

Trap: Double-charging a write-off already provided for
If a specific debt written off was already covered by the opening allowance, don't charge the full write-off AND the full required closing allowance — reduce the allowance by the write-off first, then top up only the shortfall.

Trap: Including specific/written-off balances in the general base
The general allowance % must be applied only to receivables NOT already written off or specifically provided for.

Trap: Reinstating the full original balance on recovery
Only the cash genuinely received is recognised as bad debts recovered income — not the original written-off amount.

Trap: Treating a decrease in required allowance as an expense
If the required closing allowance is LOWER than opening, the movement is INCOME, reversing the usual expense direction.

★ QUICK EXAMPLE — WRITE-OFF ALREADY COVERED

SCENARIO
Opening allowance is Rs. 80,000. A specific debt of Rs. 25,000, already covered by this allowance, is written off. The required closing allowance is recalculated at Rs. 95,000.

CALCULATION

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After write-off: 80,000 − 25,000 = 55,000
Top-up needed: 95,000 − 55,000 = Rs. 40,000
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RESULT
Doubtful debts expense for the year = **Rs. 40,000** — NOT the naive 95,000 − 80,000 = 15,000 shortcut, which ignores the write-off already absorbed.

THREE CATEGORIES
Good (certain) → no action. Doubtful (uncertain) → allowance. Bad (irrecoverable) → write off.

CALCULATION ORDER
Write off bad debts → specific allowance → general allowance on what remains.

EXPENSE RULE
Expense = Required closing allowance − Opening allowance (after adjusting for write-offs already covered).

SOFP PRESENTATION
Receivables shown NET of the allowance for doubtful debts.