Bad debts

Finance

As long as companies make sales by credit there will always remain bad debts. Forecasting for bad debts is not easy. The value of bad debts can remain consistent over time and some issues or circumstances could change that and hence increase the pile of bad debt.

To get an understanding of bad debts one has to know the many variables as possible, inside and outside, that have an effect on bad debt. Meaning of ‘ Accrual accounting’ : An accounting method that measures the performance of a company by taking into account the economic events regardless of when cash transactions occur.

The Accrual method of accounting is about matching revenues when they are earned against expenses associated with those revenues e. g. , under accrual accounting, if a business receives a bill, that bill is treated as an expense even though it has not been paid. In the same manner, if a customer is billed for an ‘ x’ amount, that bill is counted as income even though the payment has not been received yet. Accrual accounting is considered to be the norm for standard accounting with most companies, with the exception of very small operations.

This method provides a more accurate picture of the company's current condition, but its relative complexity makes it more expensive to implement. This is the opposite of cash accounting, which recognizes transactions only when there is an exchange of cash. The various ways of estimating bad-debts are as follows : i. Allowance method: One way companies derive an estimate for the value of bad debts under the allowance method is to calculate bad debts as a percentage of the accounts receivable balance. ii.

Aging method: The longer an account balance is overdue, the less likely the debt is to be paid.

Therefore, many companies maintain an accounts receivable aging schedule, which categorizes each customer's credit purchase by the length of time they have been outstanding. iii. Percentage of credit sales method: Some companies estimate bad debts as a percentage of credit sales. If a company has done $500, 000 in credit sales during an accounting period and if company records estimate that an average of 1% in credit sales become uncollectible, then an adjustment entry is passed at the end of the accounting period by debiting bad debts expense for $5, 000 and credits an allowance for bad debts for $5, 000.