

Methods for Recording Bad Debts

When a customer fails to pay their outstanding balance, the business must recognize this as an expense. The choice of method usually depends on whether the company needs to comply with Generally Accepted Accounting Principles (GAAP).

1. Direct Write-Off Method

Under this method, a bad debt is recorded **only when a specific account is deemed uncollectible**.

- **When to use:** Small businesses with few credit sales or for income tax purposes (as required by the IRS).
- **Pros:** Simple and straightforward; no estimates required.
- **Cons:** Violates the **Matching Principle** because the expense is often recorded in a different period than the related sale.

Example Entry: Direct Write-Off

If a customer, John Doe, owes \$500 and the company determines he cannot pay:

Date	Account	Debit	Credit
Dec 31	Bad Debt Expense	\$500	
	Accounts Receivable — John Doe		\$500

2. Allowance Method

The Allowance Method estimates uncollectible accounts at the end of each period. This creates a "reserve" before specific debts are identified.

- **When to use:** Required by GAAP for companies with significant credit sales.
- **Pros:** Adheres to the Matching Principle by recording the expense in the same period as the revenue.
- **Mechanism:** Uses a contra-asset account called **Allowance for Doubtful Accounts (ADA)**.

Step A: Recording the Estimate

At year-end, the company estimates that \$2,000 of its total receivables will be

uncollectible based on historical trends.

Date	Account	Debit	Credit
Dec 31	Bad Debt Expense	\$2,000	
	Allowance for Doubtful Accounts		\$2,000

Step B: Writing Off a Specific Account

Months later, a specific customer (Jane Smith) goes bankrupt, owing \$ 300. **Note:** We do not use "Bad Debt Expense" here because we already recognized the expense in Step A.

Date	Account	Debit	Credit
Mar 15	Allowance for Doubtful Accounts	\$300	
	Accounts Receivable — Jane Smith		\$300

3. Recovery of Bad Debts

Sometimes, a customer pays after their account has already been written off. This requires a two-part entry: first to reverse the write-off (restoring the receivable), and second to record the actual collection of cash.

Example Entry: Recovery (Allowance Method)

Jane Smith unexpectedly pays the \$300 previously written off.

Date	Account	Debit	Credit
Jul 20	(Part 1: Reverse Write-Off)		
	Accounts Receivable — Jane Smith	\$300	

	Allowance for Doubtful Accounts		\$300
Jul 20	(Part 2: Record Collection)		
	Cash	\$300	
	Accounts Receivable — Jane Smith		\$300

4. Estimating Bad Debts: The Aging Method

Under the Allowance Method, companies often use an **Aging of Accounts Receivable** schedule to determine the amount for the adjusting entry. This involves categorizing receivables by how long they have been past due.

Age Category	Amount	Est. % Uncollectible	Required Allowance
1–30 days	\$100,000	1 %	\$1,000
31–60 days	\$20,000	5 %	\$1,000
Over 90 days	\$5,000	25 %	\$1,250
Total			\$3,250

Summary of Methods

Feature	Direct Write-Off	Allowance Method
Matching Principle	No	Yes
GAAP Compliance	No	Yes
Primary Account	Bad Debt Expense	Allowance for Doubtful Accounts
Balance Sheet Impact	Direct reduction of A/R	Reduction via Contra-Asset

