Estimating Bad Debt Using the Allowance Method - Part 1

Why use the Allowance Method?

ıen a company offers customers the opportunity to pay later for goods/services, there is a risk that those debts may never be fulfilled. Acting as kind of a safety net, companies can prepare for possible losses from unpaid stomer debt by establishing an "allowance" account. The allowance method (compared to the direct method) method is more in line with the accrual method (GAAP-friendly).

How to Use the Allowance Method

sing the allowance method involves using a new account called, "Allowance for Doubtful Accounts". This is a ntra-asset account directly linked with accounts receivable. It has a normal credit balance and decreases over the accounting period with write-offs and increases at the end with adjusting entries.

1

+ Accounts Receivable	−
2000	500
1500	

As various debts are written off throughout the period, make sure to decrease BOTH accounts receivable and allowance for doubtful accounts.

− Allowance for Doubtful Accounts	+
500	1700
	1200

May. 3	Allowance for Doubtful Accounts	500	
	Accounts Receivable - Ted N.		500

Writing Off Bad Debts

r the accounting period when record a write-off, we take the amount owed out of the customer's ıccount (A/R) and track it with a deduction to allowance for doubtful accounts (see Fig. 2). The wance method is similar to the direct write-off method, except we don't recognize bad debt until the end of the period (no bad debts expense until the adjusting entry) .

2*

May. 3	Allowance for Doubtful Accounts	500	
	Accounts Receivable - Ted N.		500

:r the direct method, "Bad Debts Expense" would replace "Allowance for Doubtful Accounts"

Recovering Bad Debts

a write-off, sometimes a customer may unexpectedly pay off their debt. To record this event, we do a 2-part First we reinstate the debt by reversing the original write-off entry. Next we record the customer's payment of the debt (see Fig. 3).

June. 8	Accounts Receivable - Ted N.	500	
	Allowance for Doubtful Accounts		500
June. 8	Cash	500	
	Accounts Receivable - Ted N.		500