Accounting Units 3 & 4

Chapter 12 Balance day adjustments: bad and doubtful debts

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Theory

The need for balance day adjustments. A business reports its profit for a set **reporting period** — usually a year ending on **balance day** (often 30 June). Under the **accrual basis** assumption, profit is measured by matching the **revenues earned** in the period against the **expenses incurred** in earning them, regardless of when the cash is received or paid. The ordinary source documents (invoices, receipts, memos) capture most transactions, but at balance day some revenues and expenses that **belong to the period have not yet been recorded** — because no external document has arrived to trigger an entry. A **balance day adjustment (BDA)** is a General Journal entry made on balance day to bring the records up to date, so that the Income Statement reports the period's true profit and the Balance Sheet reports each asset and liability faithfully. The **allowance for doubtful debts** is one such adjustment.

Bad debts and doubtful debts. When a business sells inventory on credit it creates an **account receivable** — the right to collect cash from the customer. Experience shows that a business will not collect **every** dollar its customers owe: some customers will fail to pay.

- A **bad debt** is an amount owed by an account receivable that the business has **determined it will not collect** and has therefore *written off*. The debt is now known to be uncollectable.
- A **doubtful debt** is an amount that the business estimates it **may not collect**, but which has **not yet** been identified as a specific bad debt. At balance day the business cannot know *which* customers will default, but it can estimate — from past experience — that a **proportion** of its accounts receivable will probably prove bad.

Why estimate now? If the business waited until a debt was actually confirmed bad before recording any expense (a **direct write-off**), the expense would often fall in a **later** period than the credit sale that produced it. That would **overstate profit** in the period of the sale and **overstate Accounts Receivable** (reporting the asset at more than the business realistically expects to collect), then **understate profit** in the later period when the debt is written off. To avoid this, the business recognises the **likely** expense of doubtful debts **in the same period as the credit sales**, by creating an **Allowance for Doubtful Debts**.

The Income-Statement approach (a percentage of net credit sales). Under this method the estimated expense is calculated as a **percentage of net credit sales** for the period:

- **Net credit sales** = credit sales − credit **sales returns** (returns of goods originally sold on credit). Cash sales are excluded, because a bad debt can only arise from a **credit** sale.
- **Bad and Doubtful Debts expense** = **rate × net credit sales**. The rate (for example 2%) is based on the business's past collection experience.

This is called the *Income-Statement* approach because it focuses on measuring the **expense** and matching it to the sales revenue of the same period.

The adjusting entry. Creating the allowance requires **one** General Journal entry on balance day:

- **Debit Bad and Doubtful Debts** — an **expense** — with the estimated amount. This reduces profit in the period the related credit sales were made.
- **Credit Allowance for Doubtful Debts** — a **contra-asset** — with the same amount.

There is **no GST** on this entry: the allowance is an internal estimate, not a sale or purchase.

The Allowance is a contra-asset, not a liability. The **Allowance for Doubtful Debts** carries a **credit balance**, but it is **not** a liability. A liability is a **present obligation** to transfer economic resources to an **external party**; the allowance is not owed to anyone. Instead it is a **negative asset (a contra-asset)** — an estimate of the part of Accounts Receivable the business does **not** expect to collect. It is set **against** Accounts Receivable and reported as a **deduction** from it in the Balance Sheet.

Reporting Accounts Receivable net of the allowance. In the Balance Sheet, Accounts Receivable is shown at its full (gross) figure, then the Allowance for Doubtful Debts is **deducted** to give **net Accounts Receivable** — the amount the business realistically expects to collect:

$$\text{Net Accounts Receivable} = \text{Accounts Receivable} - \text{Allowance for Doubtful Debts}$$

Reporting the asset at this **net** figure upholds **faithful representation** (the asset is not overstated), while recognising the expense in the correct period upholds **relevance** (the period's profit reflects the sales that were actually made). The Bad and Doubtful Debts **expense** appears among the **other expenses** in the Income Statement.

Worked model. *Cedarvale Trading* is a wholesaler that reports annually to 30 June. For the year ended 30 June 2026 its **net credit sales** were $80 000. From past experience it estimates that **2%** of net credit sales will prove doubtful. At 30 June 2026 its **Accounts Receivable** balance is $40 000.

- **Allowance** = 2% × $80 000 = **$1 600**.
- **Net Accounts Receivable** = $40 000 − $1 600 = **$38 400**.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	1 600	
	Allowance for Doubtful Debts		1 600
	Allowance for doubtful debts created (2% of net credit sales $80 000)		

The Bad and Doubtful Debts expense account is **closed** at year-end by transferring its balance to the **Profit and Loss Summary** account, leaving the expense account with a nil balance, while the Allowance carries forward as a **credit balance** into the next period:

Bad and Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Allowance for Doubtful Debts	1 600	30 Jun	Profit and Loss Summary	1 600

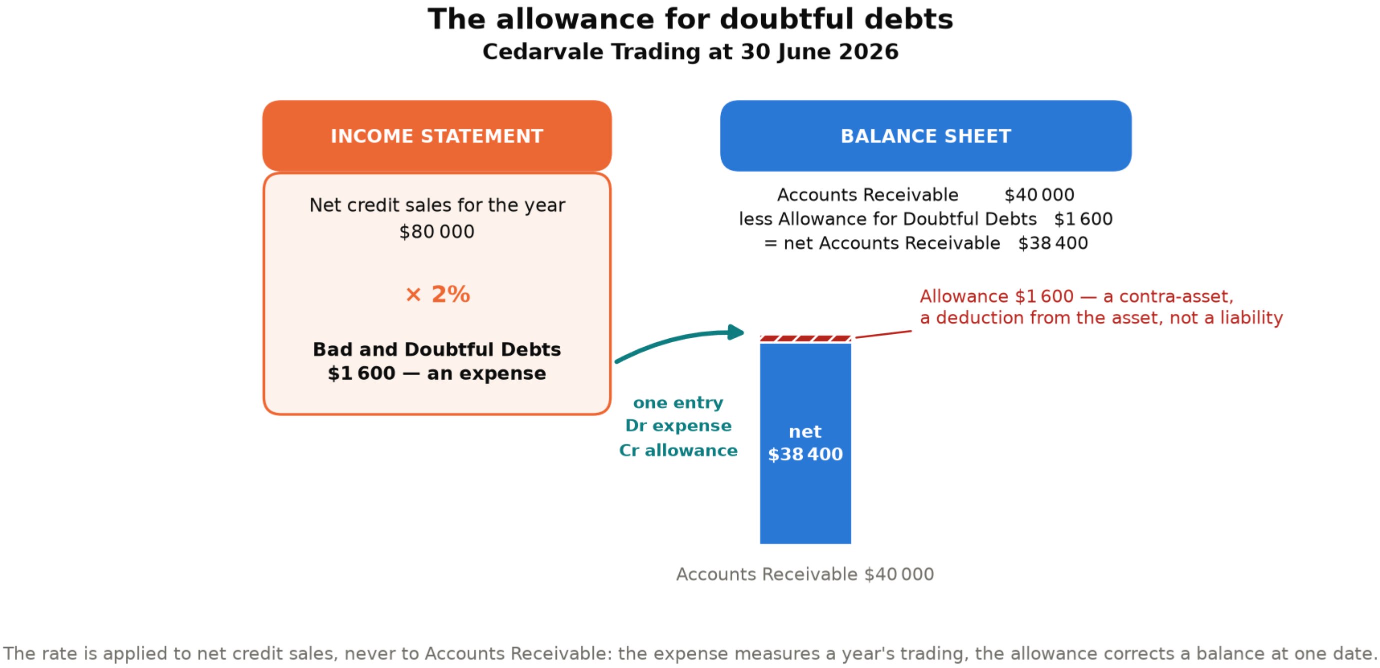
Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Balance c/d	1 600	30 Jun	Bad and Doubtful Debts	1 600
			1 Jul	Balance b/d	1 600

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Bank		5 000
Accounts Receivable	40 000	
less Allowance for Doubtful Debts	1 600	38 400
Inventory		12 000
Total Current Assets		**55 400**

The $1 600 expense reduces this year's profit, and Accounts Receivable is reported at its **net $38 400** — the cash the business realistically expects to collect.

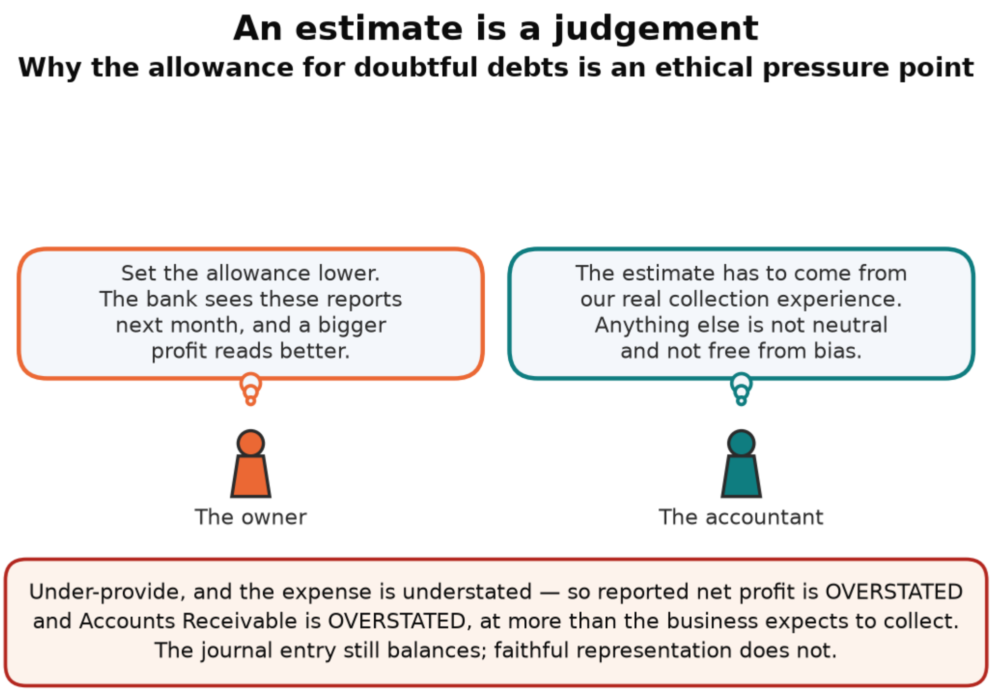


Cedarvale Trading — the expense measured against net credit sales, and the allowance deducted from Accounts Receivable

The figure separates the two dollar amounts that the one journal entry involves. The **rate is applied to net credit sales** — a flow measured across the whole year — while the **allowance is deducted from Accounts Receivable**, a balance at a single date. Applying the 2% to the $40 000 of Accounts Receivable instead of the $80 000 of net credit sales is the commonest error in this topic, and the figure shows why the two are different kinds of quantity rather than two numbers to choose between. Note too how small the allowance is against the asset it corrects: at 2% of net credit sales it is a sliver of the $40 000 owing, and the reported asset falls only to $38 400.

Ethical considerations in recording and reporting. Because the allowance for doubtful debts is an **estimate**, the size of the Bad and Doubtful Debts expense — and therefore reported net profit and the net Accounts Receivable figure — depends on a judgement the accountant makes. This creates an ethical pressure point. An owner who wants the reports to look stronger — for example, before applying for a loan or presenting results to a prospective investor — may be tempted to **under-provide** for doubtful debts, or to omit the allowance altogether. Deliberately setting the rate too low understates the expense, which **overstates net profit** in the Income Statement and **overstates Accounts Receivable** in the Balance Sheet, reporting the asset at more than the business realistically expects to collect.

The accountant has an ethical duty to record and report accounting information honestly, exercising **integrity and objectivity**: the estimate should be based on the business's genuine past collection experience, not adjusted to manufacture a flattering result. Reporting a doubtful-debts estimate that is complete, **neutral** (not slanted to favour any party) and **free from bias** upholds **faithful representation**, so that owners, lenders and other users can rely on the figures when making decisions. An estimate chosen to manipulate profit fails this test — even though the journal entry still balances — because the reports would no longer represent the business's financial position and performance faithfully.



The owner's position and the accountant's on the size of the allowance, and what under-providing does to the reports

Both positions in the figure are about the same estimate, and only one of them is anchored to evidence. The panel beneath sets out the consequence: because the expense and the allowance are the two halves of one entry, under-providing **overstates net profit** in the Income Statement and **overstates Accounts Receivable** in the Balance Sheet at the same time. The entry still balances — which is exactly why balancing is not the test that matters here.

Worked examples (scaffolded)

Example 1 — calculating the allowance and recording the adjusting entry

Brightwater Supplies reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $120 000, and it estimates that **2.5%** of net credit sales will prove doubtful. At 30 June 2026 its Accounts Receivable balance is $54 000. Create the allowance.

Working	Comment
Allowance = 2.5% × $120 000 = **$3 000**.	The Income-Statement approach applies the rate to *net credit sales*, not to the Accounts Receivable balance.
Debit Bad and Doubtful Debts $3 000 (an expense).	The estimated expense is recognised in the period the credit sales were made.
Credit Allowance for Doubtful Debts $3 000 (a contra-asset).	The allowance is set against Accounts Receivable; the entry balances ($3 000 Dr = $3 000 Cr).
Net Accounts Receivable = $54 000 − $3 000 = **$51 000**.	The Balance Sheet will report this net figure — the amount expected to be collected.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	3 000	
	Allowance for Doubtful Debts		3 000
	Allowance for doubtful debts created (2.5% of net credit sales $120 000)		

Example 2 — net credit sales from a gross figure; posting and reporting

Harrow & Lane reports annually to 30 June. During the year ended 30 June 2026 its credit sales were $95 000 and its credit **sales returns** were $5 000. It estimates that **3%** of net credit sales will prove doubtful. At 30 June 2026 its other current assets are Bank $6 000, Accounts Receivable $36 000 and Inventory $14 000. Create the allowance, post it to the ledger, and prepare the Current Assets extract.

Working	Comment
Net credit sales = $95 000 − $5 000 = **$90 000**.	Sales returns of goods sold on credit reduce credit sales before the rate is applied.
Allowance = 3% × $90 000 = **$2 700**.	Rate × net credit sales gives the estimated expense.
Dr **Bad and Doubtful Debts** $2 700; Cr **Allowance for Doubtful Debts** $2 700.	One balance day adjusting entry; no GST.
The Allowance account has a **$2 700 Cr balance**, carried forward to 1 July.	It is a contra-asset — a continuing account, not closed to Profit and Loss Summary.
Net Accounts Receivable = $36 000 − $2 700 = **$33 300**.	Reported as a deduction from Accounts Receivable.
Total Current Assets = $6 000 + $33 300 + $14 000 = **$53 300**.	Bank + net Accounts Receivable + Inventory.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	2 700	
	Allowance for Doubtful Debts		2 700
	Allowance for doubtful debts created (3% of net credit sales $90 000)		

Bad and Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Allowance for Doubtful Debts	2 700	30 Jun	Profit and Loss Summary	2 700

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Balance c/d	2 700	30 Jun	Bad and Doubtful Debts	2 700
			1 Jul	Balance b/d	2 700

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Bank		6 000
Accounts Receivable	36 000	
less Allowance for Doubtful Debts	2 700	33 300
Inventory		14 000
Total Current Assets		**53 300**

Worked examples (unscaffolded)

Example 3 — reporting the expense and the net asset

Rosslare Traders reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $150 000, and it estimates **2%** of net credit sales will prove doubtful. At 30 June 2026 its current assets are Bank $9 000, Accounts Receivable $48 000 and Inventory $16 000. Prepare the Income Statement extract for the Bad and Doubtful Debts expense and the Current Assets extract of the Balance Sheet.

The allowance is 2% × $150 000 = $3 000, so Bad and Doubtful Debts of $3 000 is reported as an other expense, and Accounts Receivable is reported net of the $3 000 allowance at $48 000 − $3 000 = $45 000. Total Current Assets are $9 000 + $45 000 + $16 000 = $70 000.

Income Statement (extract)

Income Statement (extract) for the year ended 30 June 2026	$
Other Expenses	
Bad and Doubtful Debts	3 000

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Bank		9 000
Accounts Receivable	48 000	
less Allowance for Doubtful Debts	3 000	45 000
Inventory		16 000
Total Current Assets		**70 000**

∴ the $3 000 estimated expense reduces this year's profit, and Accounts Receivable is reported at its net realisable figure of $45 000.

Example 4 — the allowance as a contra-asset

Kingsley Wholesale reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $60 000, and it estimates **1.5%** will prove doubtful. Its Accounts Receivable balance is $30 000. Create the allowance, then explain why the Allowance for Doubtful Debts is classified as a contra-asset rather than a liability, and identify the qualitative characteristic that supports reporting Accounts Receivable net of the allowance.

The allowance is 1.5% × $60 000 = $900 (Dr Bad and Doubtful Debts $900; Cr Allowance for Doubtful Debts $900), so net Accounts Receivable is $30 000 − $900 = $29 100.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	900	
	Allowance for Doubtful Debts		900
	Allowance for doubtful debts created (1.5% of net credit sales $60 000)		

The Allowance for Doubtful Debts has a credit balance, but it is **not a liability** because the business has **no present obligation to transfer economic resources to an external party** — it does not *owe* the $900 to anyone. It is a

contra-asset (a negative asset): an estimate of the portion of Accounts Receivable that will **not** produce a future economic benefit, offset against the asset it relates to. Reporting Accounts Receivable **net** of the allowance ($29 100) upholds **faithful representation**, because it reports the asset at the amount the business realistically expects to collect, so the asset is **not overstated** and the report is complete, neutral and free from material error.

∴ the Allowance is deducted from Accounts Receivable in the Balance Sheet, giving a net figure of $29 100.

Practice questions — scaffolded

Question 1

Meadowbrook Trading reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $100 000, and it estimates **2%** of net credit sales will prove doubtful. At 30 June 2026 its Accounts Receivable balance is $45 000.

a. Calculate the Allowance for Doubtful Debts.

b. Record the balance day adjustment in the General Journal.

c. Name the element of the Allowance for Doubtful Debts account, and state how Accounts Receivable is reported in the Balance Sheet.

Question 2

Fenwick Supplies reports annually to 30 June. During the year ended 30 June 2026 its credit sales were $88 000 and its credit sales returns were $8 000. It estimates **2.5%** of net credit sales will prove doubtful. Its Accounts Receivable balance is $32 000.

a. Calculate the net credit sales and the Allowance for Doubtful Debts.

b. Record the balance day adjustment in the General Journal.

c. Prepare the Current Assets extract of the Balance Sheet, showing Accounts Receivable net of the allowance. (Assume Accounts Receivable and the allowance are the only current asset items required.)

Question 3

Tanglewood Retail reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $140 000, and it estimates **1.5%** will prove doubtful. Its Accounts Receivable balance is $50 000.

a. Calculate the Allowance for Doubtful Debts, and state the net Accounts Receivable.

b. Post the adjustment to the Allowance for Doubtful Debts account and state its balance.

c. Explain, in one sentence, why the Allowance for Doubtful Debts is not classified as a liability.

Question 4

Oakridge Distributors reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $75 000, and it estimates **4%** will prove doubtful. Its Accounts Receivable balance is $28 000.

a. Record the balance day adjustment in the General Journal.

b. Post the adjustment to the Bad and Doubtful Debts account and the Allowance for Doubtful Debts account.

c. State the report in which each of these two accounts appears.

Question 5

Pinehurst Trading reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $110 000, and it estimates **3%** will prove doubtful. Its Accounts Receivable balance is $40 000.

a. Calculate the allowance and record the balance day adjustment in the General Journal.

b. Prepare the Current Assets extract of the Balance Sheet, showing Accounts Receivable net of the allowance.

c. Identify the qualitative characteristic that supports creating the allowance, and explain your choice in one sentence.

Question 6

Delford Trading reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $90 000, and it estimates **2%** will prove doubtful.

a. Distinguish between a **bad debt** and a **doubtful debt**.

b. Explain why the business creates an allowance now rather than waiting to write off debts as they are confirmed. Refer to the accrual basis and the period assumption.

c. State the amount of the Bad and Doubtful Debts expense and name the account credited when the allowance is created.

Practice questions — unscaffolded

Question 7

Ashmore Wholesale reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $200 000, and it estimates **2%** will prove doubtful. Its Accounts Receivable balance is $70 000. Record the balance day adjustment in the General Journal, and state the net Accounts Receivable reported in the Balance Sheet.

Question 8

Belmont Traders reports annually to 30 June. During the year ended 30 June 2026 its credit sales were $130 000 and its credit sales returns were $10 000. It estimates **2.5%** of net credit sales will prove doubtful. Its Accounts Receivable balance is $55 000. Calculate the net credit sales and the allowance, record the balance day adjustment in the General Journal, and state the net Accounts Receivable.

Question 9

Carrington Supplies reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $160 000, and it estimates **1.25%** will prove doubtful. Its Accounts Receivable balance is $44 000. Record the balance day adjustment in the General Journal and prepare the Current Assets extract of the Balance Sheet (Accounts Receivable net of the allowance).

Question 10

Dunmore Distributors reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $85 000, and it estimates **2%** will prove doubtful. Its Accounts Receivable balance is $38 000. Prepare the Bad and Doubtful Debts account and the Allowance for Doubtful Debts account (showing the balance carried down), and state the net Accounts Receivable.

Question 11

Everton Trading reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $250 000, and it estimates **3%** will prove doubtful. At 30 June 2026 its current assets are Bank $12 500, Accounts Receivable $90 000 and Inventory $25 000. Prepare the Income Statement extract for the Bad and Doubtful Debts expense and the Current Assets extract of the Balance Sheet.

Question 12

Foxglove Retail reports annually to 30 June. During the year ended 30 June 2026 its credit sales were $105 000 and its credit sales returns were $5 000. It estimates **3.5%** of net credit sales will prove doubtful. At 30 June 2026 its current assets are Bank $5 500, Accounts Receivable $42 000 and Inventory $16 000. Record the balance day adjustment in the General Journal, prepare the Allowance for Doubtful Debts account, and prepare the Current Assets extract of the Balance Sheet.

Question 13

Granville Wholesale created an Allowance for Doubtful Debts of $2 400 at 30 June 2026, being **2%** of its net credit sales for the year. Using this information, calculate the net credit sales for the year ended 30 June 2026. (You are not required to prepare any journal or ledger.)

Question 14

Hazelwood Trading reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $180 000, and it estimates **2.5%** will prove doubtful. Its Accounts Receivable balance is $60 000. Prepare the Income Statement extract for the Bad and Doubtful Debts expense and the Current Assets extract of the Balance Sheet (Accounts Receivable net of the allowance).

Question 15

Explain why a business creates an **allowance for doubtful debts** rather than simply writing off each bad debt directly when it is confirmed uncollectable. In your answer, refer to the **period** assumption and to **why Accounts Receivable is reported net of the allowance** in the Balance Sheet.

Question 16

A student argues that because the Allowance for Doubtful Debts has a credit balance, it should be reported as a current liability. Explain why the Allowance for Doubtful Debts is instead classified as a **contra-asset**, and identify the qualitative characteristic that is upheld by reporting Accounts Receivable net of the allowance.

Question 17

Inglewood Supplies reports annually to 30 June. For the year ended 30 June 2026 its net credit sales were $96 000, and it estimates **2.5%** will prove doubtful. Its Accounts Receivable balance is $34 000. Record the balance day adjustment in the General Journal, prepare the Current Assets extract of the Balance Sheet, and explain in one or two sentences why reporting the net Accounts Receivable is more useful to a lender assessing the business than reporting the gross figure.

Question 18

Jarrah Trading reports annually to 30 June. During the year ended 30 June 2026 its credit sales were $220 000 and its credit sales returns were $20 000. It estimates **3%** of net credit sales will prove doubtful. At 30 June 2026 its current assets are Bank $11 000, Accounts Receivable $80 000 and Inventory $20 000. Record the balance day adjustment in the General Journal, prepare the Bad and Doubtful Debts account and the Allowance for Doubtful Debts account, and prepare the Income Statement extract and the Current Assets extract of the Balance Sheet.

Question 19

The owner of *Marlowe Trading* is preparing to apply to the bank for a loan and asks the accountant to reduce the Allowance for Doubtful Debts from the usual **2.5%** of net credit sales to **1%** “just for this year”, so that reported net profit and Accounts Receivable will look stronger to the lender. Discuss the ethics of the owner’s request, referring to the accountant’s responsibility and to the effect on **faithful representation**, and explain how the accountant should respond.

Question 20

Norwood Distributors has always estimated doubtful debts at **3%** of net credit sales, consistent with its collection experience. This year several customers have been slow to pay and the owner privately expects the bad-debt rate to rise, but instructs the accountant to leave the allowance out entirely so that this year’s profit is not reduced. Discuss the ethical considerations raised, identifying the qualitative characteristic and the accountant’s obligations, and state what the accountant should do.

Answers

1.
   a. $2 000 c. Contra-asset (negative asset); Accounts Receivable reported net of the allowance ($43 000)
2.
   a. Net credit sales $80 000; allowance $2 000 c. Net Accounts Receivable $30 000
3.
   a. $2 100; net Accounts Receivable $47 900 b. $2 100 Cr
4.
   a. Dr Bad and Doubtful Debts $3 000; Cr Allowance for Doubtful Debts $3 000 c. Bad and Doubtful Debts → Income Statement; Allowance for Doubtful Debts → Balance Sheet
5.
   a. $3 300 b. Net Accounts Receivable $36 700 c. Relevance (see solutions)
6.
   c. Expense $1 800; credit Allowance for Doubtful Debts
7. Dr Bad and Doubtful Debts $4 000; Cr Allowance for Doubtful Debts $4 000; net Accounts Receivable $66 000
8. Net credit sales $120 000; allowance $3 000; net Accounts Receivable $52 000
9. Allowance $2 000; net Accounts Receivable $42 000
10. Allowance $1 700 Cr; net Accounts Receivable $36 300
11. Bad and Doubtful Debts $7 500; net Accounts Receivable $82 500; Total Current Assets $120 000
12. Net credit sales $100 000; allowance $3 500; net Accounts Receivable $38 500; Total Current Assets $60 000
13. Net credit sales $120 000
14. Bad and Doubtful Debts $4 500; net Accounts Receivable $55 500
15. See solutions
16. See solutions
17. Allowance $2 400; net Accounts Receivable $31 600
18. Net credit sales $200 000; allowance $6 000; net Accounts Receivable $74 000; Total Current Assets $105 000
19. See solutions
20. See solutions

Fully-worked solutions

Question 1

a. Allowance = 2% × $100 000 = **$2 000**.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	2 000	
	Allowance for Doubtful Debts		2 000
	Allowance for doubtful debts created (2% of net credit sales $100 000)		

c. The **Allowance for Doubtful Debts** is a **contra-asset** (a negative asset). Accounts Receivable is reported in the Balance Sheet at its gross figure **less** the allowance — a **net** $45 000 − $2 000 = **$43 000**.

Question 2

a. Net credit sales = $88 000 − $8 000 = **$80 000**; allowance = 2.5% × $80 000 = **$2 000**.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	2 000	
	Allowance for Doubtful Debts		2 000
	Allowance for doubtful debts created (2.5% of net credit sales $80 000)		

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Accounts Receivable	32 000	
less Allowance for Doubtful Debts	2 000	30 000

Net Accounts Receivable = $32 000 − $2 000 = **$30 000**.

Question 3

a. Allowance = 1.5% × $140 000 = **$2 100**; net Accounts Receivable = $50 000 − $2 100 = **$47 900**.

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Balance c/d	2 100	30 Jun	Bad and Doubtful Debts	2 100
			1 Jul	Balance b/d	2 100

The account has a **balance of $2 100 Cr**, carried forward to the next period.

c. The Allowance for Doubtful Debts is **not** a liability because the business has **no present obligation to pay anyone** — it is an estimate of Accounts Receivable that will not be collected, offset against that asset.

Question 4

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	3 000	
	Allowance for Doubtful Debts		3 000
	Allowance for doubtful debts created (4% of net credit sales $75 000)		

Bad and Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Allowance for Doubtful Debts	3 000	30 Jun	Profit and Loss Summary	3 000

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Balance c/d	3 000	30 Jun	Bad and Doubtful Debts	3 000
			1 Jul	Balance b/d	3 000

c. **Bad and Doubtful Debts** is an **expense**, reported in the **Income Statement**; **Allowance for Doubtful Debts** is a **contra-asset**, reported in the **Balance Sheet** as a deduction from Accounts Receivable.

Question 5

a. Allowance = 3% × $110 000 = **$3 300**.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	3 300	
	Allowance for Doubtful Debts		3 300
	Allowance for doubtful debts created (3% of net credit sales $110 000)		

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Accounts Receivable	40 000	
less Allowance for Doubtful Debts	3 300	36 700

Net Accounts Receivable = $40 000 − $3 300 = **$36 700**.

c. **Relevance.** Creating the allowance recognises the estimated Bad and Doubtful Debts expense in the **same period** as the credit sales that generated it, so the period's profit is relevant to decision making; reporting Accounts Receivable net of the allowance also reports the asset at the amount expected to be collected. (Faithful representation is also upheld, because the asset is not overstated.)

Question 6

a. A **bad debt** is an amount owed by an account receivable that the business has **determined it will not collect** and has written off — it is known to be uncollectable. A **doubtful debt** is an amount that the business estimates it **may not** collect, but which has **not yet** been identified as a specific bad debt.

b. Under the **period assumption**, the life of the business is divided into reporting periods so that the profit of each one can be determined separately, and under the **accrual basis** the expense of debts going bad should be recognised in the **same period** as the credit sales that produced it, so that profit is measured by matching the expenses incurred against the revenues earned. If the business waited until each debt was confirmed bad, the expense would often fall in a **later** period, overstating profit (and Accounts Receivable) now and understating profit later. Creating the allowance at balance day recognises the likely expense in the correct period.

c. The Bad and Doubtful Debts expense is 2% × $90 000 = **$1 800**; the account credited when the allowance is created is **Allowance for Doubtful Debts**.

Question 7

Allowance = 2% × $200 000 = $4 000; net Accounts Receivable = $70 000 − $4 000 = $66 000.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	4 000	
	Allowance for Doubtful Debts		4 000
	Allowance for doubtful debts created (2% of net credit sales $200 000)		

Net Accounts Receivable reported in the Balance Sheet = **$66 000**.

Question 8

Net credit sales = $130 000 − $10 000 = $120 000; allowance = 2.5% × $120 000 = $3 000; net Accounts Receivable = $55 000 − $3 000 = $52 000.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	3 000	
	Allowance for Doubtful Debts		3 000
	Allowance for doubtful debts created (2.5% of net credit sales $120 000)		

∴ net Accounts Receivable = **$52 000**.

Question 9

Allowance = 1.25% × $160 000 = $2 000; net Accounts Receivable = $44 000 − $2 000 = $42 000.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	2 000	
	Allowance for Doubtful Debts		2 000
	Allowance for doubtful debts created (1.25% of net credit sales $160 000)		

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Accounts Receivable	44 000	
less Allowance for Doubtful Debts	2 000	42 000

Question 10

Allowance = 2% × $85 000 = $1 700; net Accounts Receivable = $38 000 − $1 700 = $36 300.

Bad and Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Allowance for Doubtful Debts	1 700	30 Jun	Profit and Loss Summary	1 700

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Balance c/d	1 700	30 Jun	Bad and Doubtful Debts	1 700
			1 Jul	Balance b/d	1 700

∴ the Allowance carries a **$1 700 Cr** balance and net Accounts Receivable = **$36 300**.

Question 11

Allowance = 3% × $250 000 = $7 500; net Accounts Receivable = $90 000 − $7 500 = $82 500; Total Current Assets = $12 500 + $82 500 + $25 000 = $120 000.

Income Statement (extract)

Income Statement (extract) for the year ended 30 June 2026	$
Other Expenses	
Bad and Doubtful Debts	7 500

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Bank		12 500
Accounts Receivable	90 000	
less Allowance for Doubtful Debts	7 500	82 500
Inventory		25 000
Total Current Assets		**120 000**

Question 12

Net credit sales = $105 000 − $5 000 = $100 000; allowance = 3.5% × $100 000 = $3 500; net Accounts Receivable = $42 000 − $3 500 = $38 500; Total Current Assets = $5 500 + $38 500 + $16 000 = $60 000.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	3 500	
	Allowance for Doubtful Debts		3 500
	Allowance for doubtful debts created (3.5% of net credit sales $100 000)		

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Balance c/d	3 500	30 Jun	Bad and Doubtful Debts	3 500
			1 Jul	Balance b/d	3 500

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Bank		5 500
Accounts Receivable	42 000	
less Allowance for Doubtful Debts	3 500	38 500
Inventory		16 000
Total Current Assets		**60 000**

Question 13

The allowance is 2% of net credit sales, so net credit sales = allowance ÷ rate:

net credit sales = $2 400 ÷ 0.02 = **$120 000**.

∴ the net credit sales for the year ended 30 June 2026 were **$120 000**.

Question 14

Allowance = 2.5% × $180 000 = $4 500; net Accounts Receivable = $60 000 − $4 500 = $55 500.

Income Statement (extract)

Income Statement (extract) for the year ended 30 June 2026	$
Other Expenses	
Bad and Doubtful Debts	4 500

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Accounts Receivable	60 000	
less Allowance for Doubtful Debts	4 500	55 500

Question 15

Writing off each bad debt only when it is confirmed uncollectable (a **direct write-off**) records the expense when the debt is finally known to be bad — which is often in a **later reporting period** than the credit sale that produced it. This breaches the **period** assumption — which requires the life of the business to be divided into periods so that the profit of each one can be determined separately — and the **accrual basis**, under which the expense of doubtful debts should be recognised in the **same period** as the related credit sales, so that each period's profit is measured by matching its expenses against its revenues. Deferring the expense would overstate profit in the period of the sale and understate it later.

Creating an **allowance** at balance day estimates the likely expense now, so it falls in the correct period. **Accounts Receivable is then reported net of the allowance** in the Balance Sheet because a business does not expect to collect **every** dollar owed; deducting the allowance reports the asset at the amount the business realistically expects to receive, upholding **faithful representation** — the asset is not overstated and the report is complete, neutral and free from material error.

Question 16

Although the Allowance for Doubtful Debts has a **credit balance**, it is **not** a liability, because a liability is a **present obligation to transfer economic resources to an external party**, and the business does **not owe** the allowance to anyone — it is not a debt payable. The allowance is instead a **contra-asset (a negative asset)**: an estimate of the portion of Accounts Receivable that is **not** expected to produce a future economic benefit. It is therefore reported in the Balance Sheet as a **deduction from Accounts Receivable**, not among the liabilities.

Reporting Accounts Receivable **net** of the allowance upholds **faithful representation**, because the asset is reported at the amount the business realistically expects to collect — it is not overstated, and the information is complete, neutral and free from material error.

Question 17

Allowance = 2.5% × $96 000 = $2 400; net Accounts Receivable = $34 000 − $2 400 = $31 600.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	2 400	
	Allowance for Doubtful Debts		2 400
	Allowance for doubtful debts created (2.5% of net credit sales $96 000)		

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Accounts Receivable	34 000	
less Allowance for Doubtful Debts	2 400	31 600

The net figure of **$31 600** tells the lender the amount the business **realistically expects to collect** from its customers, rather than the gross $34 000 that assumes every customer will pay. This is a more faithful (and more relevant) basis for assessing the business's ability to convert its receivables into cash and meet its debts.

Question 18

Net credit sales = $220 000 − $20 000 = $200 000; allowance = 3% × $200 000 = $6 000; net Accounts Receivable = $80 000 − $6 000 = $74 000; Total Current Assets = $11 000 + $74 000 + $20 000 = $105 000.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	6 000	
	Allowance for Doubtful Debts		6 000
	Allowance for doubtful		

Date 2026	Details	Debit $	Credit $
	debts created (3% of net credit sales $200 000)		

Bad and Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Allowance for Doubtful Debts	6 000	30 Jun	Profit and Loss Summary	6 000

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Balance c/d	6 000	30 Jun	Bad and Doubtful Debts	6 000
			1 Jul	Balance b/d	6 000

Income Statement (extract)

Income Statement (extract) for the year ended 30 June 2026	$
Other Expenses	
Bad and Doubtful Debts	6 000

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Bank		11 000
Accounts Receivable	80 000	
less Allowance for Doubtful Debts	6 000	74 000
Inventory		20 000
Total Current Assets		**105 000**

Question 19

The owner is asking the accountant to deliberately understate an estimate in order to make the reports look better to the bank. Reducing the rate from 2.5% to 1% would understate the Bad and Doubtful Debts expense, which would **overstate net profit** in the Income Statement, and would understate the allowance, which would **overstate net Accounts Receivable** in the Balance Sheet — reporting the asset at more than the business realistically expects to collect. The estimate would no longer be based on the business's genuine collection experience, but chosen to produce a favourable result for one particular user.

This breaches **faithful representation**: the reports would not be **complete, neutral or free from bias**, because they would be deliberately slanted to influence the lender's decision. It also breaches the accountant's ethical duty to act with **integrity and objectivity** — to record and report information honestly, without allowing the owner's interests to distort the figures. Presenting overstated profit and assets to obtain finance is misleading, and could expose both the business and the accountant to serious consequences if the lender later relies on figures that prove false.

∴ the accountant should **decline** to alter the estimate. They should explain to the owner that the allowance must reflect the business's realistic expectation of uncollectable debts (its past collection experience), that reporting is required to be neutral and free from bias, and that presenting overstated profit and assets to a lender is both misleading and unethical. The accountant should record the allowance at the rate genuinely justified by the evidence.

Question 20

Leaving the allowance out entirely is an even clearer breach. Because the owner actually **expects** the bad-debt rate to rise, omitting the allowance would knowingly understate the Bad and Doubtful Debts expense so as to **overstate net profit**, and would omit a contra-asset needed to report Accounts Receivable at the amount realistically expected to be collected, thereby **overstating the asset**. Since the omission is deliberate and the owner expects debts to worsen, it cannot be defended as an honest estimate.

The qualitative characteristic at stake is **faithful representation** — information should be complete, **neutral** and **free from bias** (and free from material error). Omitting a known likely expense makes the reports **incomplete** and biased in the owner's favour, so users cannot rely on them. The accountant's obligations of **integrity and objectivity** require honest reporting regardless of the effect on this year's profit; profit should not be managed by suppressing a legitimate estimate.

∴ the accountant should **refuse** to omit the allowance and should create it at the rate supported by the business's collection experience (here at least the usual 3%, or higher if the evidence now points to more defaults). They should explain to the owner that the expense belongs to this period under the accrual basis, and that faithful, unbiased reporting protects the users of the reports and the integrity of the business's records.

Chapter 12 Balance day adjustments: bad and doubtful debts — 12B Writing off bad debts in subsequent periods

Theory

In the previous section a business estimated the debts it might not collect and raised an **Allowance for Doubtful Debts**. The allowance is a **contra-asset** — it sits against Accounts Receivable in the Balance Sheet, reducing the gross receivables to the **net amount the business realistically expects to collect** (the *net realisable value*). The estimate is recorded with a single balance day adjustment:

- **Dr Bad and Doubtful Debts** (an expense), and
- **Cr Allowance for Doubtful Debts** (a contra-asset).

A **doubtful debt** is only an *estimate* — the business does not yet know *which* customers will fail to pay. A **bad debt** is different: it is an **actual** debt that has now become **certain to be uncollectable** (for example, the customer has been declared bankrupt or has ceased trading). When a specific debt turns bad, it must be removed from Accounts Receivable. Because an allowance was already created for exactly this purpose, the debt is **written off against the allowance** — this is the **allowance method**.

The write-off entry. Assume a customer owes a **GST-inclusive** amount that is now certain to be lost. Under the allowance method the write-off is recorded as:

- **Dr Allowance for Doubtful Debts** — the **GST-exclusive** amount of the debt. The allowance was raised on net credit sales (which exclude GST), so it is the GST-exclusive portion that is drawn down.
- **Dr GST Clearing — 1/11 of the GST-inclusive debt**. When the original credit sale was made, the business credited GST Clearing with the GST it charged, *increasing the GST it owed the ATO* even though no cash had been received. Because the customer will now never pay, that GST will never be collected, so the business claims a **decreasing adjustment**: GST Clearing is debited to **reverse the GST originally recorded** on the sale.
- **Cr Accounts Receivable** — the full **GST-inclusive** debt, removing it from the Accounts Receivable account in the General Ledger.

The debit (GST-exclusive) plus the GST debit equals the GST-inclusive credit, so the entry balances.

The effect on the allowance balance. Debiting the Allowance for Doubtful Debts **reduces** its credit balance. The allowance was set aside to absorb debts that later prove bad; writing off an actual bad debt simply **uses up part of the allowance**. If the total of the debts written off during a period is *less* than the opening allowance, the account keeps a credit balance; if the write-offs *exceed* the opening allowance, the account is temporarily overdrawn and shows a **debit balance** — a signal that the prior estimate was too low.

Why writing off a bad debt does NOT create a new expense. This is the key idea of the allowance method. The **Bad and Doubtful Debts expense was already recognised** in the period the allowance was raised — the period in which the credit sales (revenue) were earned. Recognising the estimated expense then, rather than waiting, applies the **accrual basis** assumption: the cost of selling on credit is matched to the revenue that created it. When the debt later turns bad, the sacrifice has *already* been reported, so the write-off only:

- reduces the **Allowance for Doubtful Debts** (a contra-asset), and
- reduces **Accounts Receivable** (an asset), and
- reverses the **GST**.

No expense account is touched. Recording an expense again on write-off would **double-count** the same cost and understate profit in the later period.

Topping up the allowance at the next balance day. During the year the allowance is drawn down by write-offs. At the **next balance day** the business re-estimates the bad debts expected from *that year's* trading — the **Income-Statement approach**, a percentage of the period's **net credit sales** — and records a fresh balance day adjustment (Dr Bad and Doubtful Debts; Cr Allowance for Doubtful Debts). This new credit **tops the allowance back up**. If write-offs had pushed the allowance into a debit balance, the balance day adjustment **re-establishes** a credit balance.

Reporting.

- The **Income Statement** reports the **Bad and Doubtful Debts expense** — the balance day estimate. The write-off of a specific bad debt is *not* a separate expense and never appears here.
- The **Balance Sheet** reports **Accounts Receivable less the Allowance for Doubtful Debts = net Accounts Receivable**, the amount expected to be collected. Both a write-off (which lowers gross AR) and the closing allowance affect this net figure.

The allowance method versus the direct write-off method. Under the **direct write-off method** no allowance is raised; a Bad Debts expense is recognised only when a specific debt is judged uncollectable. That records the expense in whatever period the debt turns bad — often *later* than the sale — and leaves Accounts Receivable overstated in the meantime. The **allowance method** matches the expense to the period of the sale (accrual basis) and reports receivables at net realisable value (relevance and faithful representation), so it is the method required by the study design.

Worked model. At 30 June 2025 Meridian Office Supplies raised an Allowance for Doubtful Debts of $720 (2% of $36 000 net credit sales). On 12 August 2025 a customer, J. Prentice, was declared bankrupt and the debt of $330 (including GST) was written off (Memo 41).

Date 2025	Details	Debit $	Credit $
12 Aug	Allowance for Doubtful Debts	300	
	GST Clearing	30	
	Accounts Receivable		330
	Bad debt of J. Prentice written off against the allowance (Memo 41)		

The GST reversal is 1/11 × $330 = $30, so the GST-exclusive amount drawn from the allowance is $330 − $30 = **$300**. The allowance falls from $720 to $720 − $300 = **$420**. No expense is recorded — the $720 expense was recognised back on 30 June 2025.

Worked examples (scaffolded)

Example 1 — writing off a bad debt with a GST reversal

At 30 June 2025 Coastal Freight Services carried an Allowance for Doubtful Debts of $900. On 9 September 2025 it learned that a customer, Harbourline Logistics, had gone into liquidation and its debt of $550 (including GST) was irrecoverable. The debt was written off (Memo 27).

Working	Comment
GST reversal = 1/11 × $550 = **$50**.	The debt is GST-inclusive; the GST is exactly 1/11 of it. Debiting GST Clearing reverses the GST recorded on the original sale.
GST-exclusive amount = $550 − $50 = **$500** → debited to the allowance.	The allowance was raised on net (GST-exclusive) credit sales, so only the $500 is drawn from it.
Cr Accounts Receivable $550 (full inclusive debt).	The whole amount owing leaves Accounts Receivable.
Dr $500 + Dr $50 = Cr $550 → the entry balances.	Two debits offset one credit.
Allowance after write-off = $900 − $500 = **$400**.	Debiting the allowance reduces its credit balance; no expense is recorded.

Date 2025	Details	Debit $	Credit $
9 Sep	Allowance for Doubtful Debts	500	

Date 2025	Details	Debit $	Credit $
	GST Clearing	50	
	Accounts Receivable		550
	Bad debt of Harbourline Logistics written off against the allowance (Memo 27)		

Example 2 — write-off during the year, then topping up the allowance at balance day

At 30 June 2025 Delta Stationery carried an Allowance for Doubtful Debts of $640. On 4 November 2025 a customer's debt of $220 (including GST) was written off (Memo 33). Net credit sales for the year ended 30 June 2026 were $38 000, and the business estimates 2% of net credit sales will prove doubtful.

Working	Comment
Write-off: GST = 1/11 × $220 = $20; GST-exclusive = **$200**.	Dr Allowance $200; Dr GST Clearing $20; Cr Accounts Receivable $220.
Allowance after the write-off = $640 − $200 = **$440**.	The allowance is drawn down but keeps a credit balance.
Balance day adjustment = 2% × $38 000 = **$760**.	The new estimate uses *this year's* net credit sales (Income-Statement approach).
Dr Bad and Doubtful Debts $760; Cr Allowance for Doubtful Debts $760.	This is the expense reported in the Income Statement.
Allowance after top-up = $440 + $760 = **$1 200**.	The fresh adjustment tops the allowance back up.

Date 2025	Details	Debit $	Credit $
4 Nov	Allowance for Doubtful Debts	200	
	GST Clearing	20	
	Accounts Receivable		220
	Bad debt written off against the allowance (Memo 33)		

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	760	
	Allowance for Doubtful Debts		760
	Allowance topped up to 2% of net credit sales at balance day		

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2025			2025		
4 Nov	Accounts Receivable	200	1 Jul	Balance	640

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2026			2026		
30 Jun	Balance c/d	1 200	30 Jun	Bad and Doubtful Debts	760
		1 400			1 400
			1 Jul	Balance b/d	1 200

Worked examples (unscaffolded)

Example 3 — reporting net Accounts Receivable after a write-off

At 30 June 2025 Ironbark Timber & Hardware carried Accounts Receivable of $22 000 and an Allowance for Doubtful Debts of $1 000. On 15 October 2025 a customer's debt of $880 (including GST) was written off as bad (Memo 52). Record the write-off and show how Accounts Receivable would be reported in the Balance Sheet immediately afterwards.

The GST reversal is 1/11 × $880 = $80, so $800 is drawn from the allowance and $880 leaves Accounts Receivable.

Date 2025	Details	Debit $	Credit $
15 Oct	Allowance for Doubtful Debts	800	
	GST Clearing	80	
	Accounts Receivable		880
	Bad debt written off against the allowance (Memo 52)		

Accounts Receivable falls to $22 000 − $880 = $21 120 and the allowance falls to $1 000 − $800 = $200.

Balance Sheet (extract) as at 15 October 2025

Current Assets	$	$
Accounts Receivable	21 120	
less Allowance for Doubtful Debts	200	20 920

∴ net Accounts Receivable is reported at **$20 920**, the amount the business still expects to collect.

Example 4 — write-offs exceed the allowance, then the allowance is re-established

At 30 June 2025 Summit Electrical Wholesale carried an Allowance for Doubtful Debts of $500. On 20 August 2025 a customer's debt of $660 (including GST) was written off (Memo 18). Net credit sales for the year ended 30 June 2026 were $40 000 and the business estimates 2% will be doubtful. Show the Allowance for Doubtful Debts ledger for the year.

The write-off draws $600 (GST-exclusive) from the allowance, which had only $500 in it, so the account is briefly **overdrawn by $100 (a debit balance)** — the prior estimate was too low. The balance day adjustment of 2% × $40 000 = $800 re-establishes a credit balance of $700.

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2025			2025		
20 Aug	Accounts	600	1 Jul	Balance	500

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
	Receivable				
2026			2026		
30 Jun	Balance c/d	700	30 Jun	Bad and Doubtful Debts	800
		1 300			1 300
			1 Jul	Balance b/d	700

∴ after the balance day adjustment the allowance is a **$700 credit balance**; the $100 debit balance existed only between the write-off and balance day.

Practice questions — scaffolded

Question 1

At 30 June 2025 Brookdale Motors carried an Allowance for Doubtful Debts of $800. On 3 September 2025 a customer's debt of $440 (including GST) became irrecoverable and was written off (Memo 15).

a. Record the write-off in the General Journal.

b. State the amount of GST reversed, and explain in one sentence why GST Clearing is debited.

c. State the balance of the Allowance for Doubtful Debts immediately after the write-off.

Question 2

At 30 June 2025 Fairview Traders carried Accounts Receivable of $18 000 and an Allowance for Doubtful Debts of $600. On 11 October 2025 a customer's debt of $330 (including GST) was written off (Memo 22).

a. Record the write-off in the General Journal.

b. State the balance of Accounts Receivable immediately after the write-off.

c. State the net Accounts Receivable that would be reported in the Balance Sheet immediately after the write-off.

Question 3

At 30 June 2025 Kingsley Plumbing Supplies carried an Allowance for Doubtful Debts of $500. On 7 December 2025 a customer's debt of $220 (including GST) was written off (Memo 31). Net credit sales for the year ended 30 June 2026 were $30 000; the business estimates 2% will be doubtful.

a. Record the write-off and the balance day adjustment in the General Journal.

b. Prepare the Allowance for Doubtful Debts ledger account for the year, balanced as at 30 June 2026.

c. State the amount of the balance day adjustment.

Question 4

At 30 June 2025 Marlow Furniture carried an Allowance for Doubtful Debts of $700. On 18 September 2025 a customer's debt of $550 (including GST) was written off (Memo 9).

a. Record the write-off in the General Journal.

b. State the effect of this write-off on total assets and on total liabilities, showing your calculations.

c. Name the qualitative characteristic that supports reporting Accounts Receivable net of the allowance, and justify your choice in one sentence.

Question 5

At 30 June 2025 Pinehill Electrical carried an Allowance for Doubtful Debts of $650. On 25 November 2025 a customer's debt of $330 (including GST) was written off (Memo 14).

a. Record the write-off in the General Journal.

b. State the balance of the Allowance for Doubtful Debts immediately after the write-off.

c. Explain what a **debit balance** in the Allowance for Doubtful Debts would indicate, and state how such a balance is corrected at the next balance day.

Question 6

At 30 June 2025 Redgum Building Supplies carried an Allowance for Doubtful Debts of $400. During the year ended 30 June 2026 two debts were written off: $220 (including GST) on 14 August 2025 (Memo 6) and $330 (including GST) on 2 March 2026 (Memo 19). Net credit sales for the year were $35 000; 2% is estimated to be doubtful.

a. Record the two write-offs in the General Journal.

b. State the balance of the Allowance for Doubtful Debts immediately before the balance day adjustment, and whether it is a debit or credit balance.

c. State the balance of the allowance after the balance day adjustment on 30 June 2026.

Practice questions — unscaffolded

Question 7

At 30 June 2025 Southport Marine carried an Allowance for Doubtful Debts of $950. On 12 September 2025 a customer's debt of $770 (including GST) was written off (Memo 24). Record the write-off in the General Journal and state the balance of the allowance immediately afterwards.

Question 8

At 30 June 2025 Tarrant Wholesalers carried Accounts Receivable of $26 400 and an Allowance for Doubtful Debts of $1 100. On 4 November 2025 a customer's debt of $1 100 (including GST) was written off (Memo 40). Record the write-off, and state the balance of Accounts Receivable and the net Accounts Receivable reported immediately afterwards.

Question 9

At 30 June 2025 Vale Agricultural Supplies carried an Allowance for Doubtful Debts of $1 200. During the following year two debts were written off: $440 (including GST) on 19 August 2025 (Memo 11) and $660 (including GST) on 6 January 2026 (Memo 28). Prepare the Allowance for Doubtful Debts ledger account showing both write-offs, and state the balance of the account after them.

Question 10

At 30 June 2025 Westbrook Tools carried an Allowance for Doubtful Debts of $600. On 30 October 2025 a customer's debt of $330 (including GST) was written off (Memo 17). Net credit sales for the year ended 30 June 2026 were $44 000; the business estimates 2% will be doubtful. Prepare the Allowance for Doubtful Debts ledger account for the year, balanced as at 30 June 2026.

Question 11

At 30 June 2025 Ashgrove Joinery carried an Allowance for Doubtful Debts of $450. During the year ended 30 June 2026 it wrote off $550 (including GST) on 21 September 2025 (Memo 7) and $220 (including GST) on 17 April 2026 (Memo 30). Net credit sales for the year were $42 000; 2.5% is estimated to be doubtful. Prepare the Allowance for Doubtful Debts ledger account for the year, and state the balance of the allowance immediately before the balance day adjustment.

Question 12

Cedarwood Interiors wrote off a bad debt of $660 (including GST) against its Allowance for Doubtful Debts during the year. Explain why this write-off is not reported as an expense in the Income Statement, with reference to the period in which the expense was recognised.

Question 13

Northbridge Supplies is deciding whether to use the allowance method or the direct write-off method for its bad debts. Distinguish the two methods, referring to the timing of the expense and the valuation of Accounts Receivable, and state which the study design requires.

Question 14

Explain why a business creates an Allowance for Doubtful Debts and reports Accounts Receivable net of that allowance, with reference to **two** qualitative characteristics.

Question 15

At 30 June 2025 Oakland Distributors carried an Allowance for Doubtful Debts of $900. During the year ended 30 June 2026 it wrote off one bad debt of $440 (including GST). After the balance day adjustment on 30 June 2026 the Allowance for Doubtful Debts had a credit balance of $1 300. Using account reconstruction, calculate the balance day adjustment recorded on 30 June 2026. (You are not required to prepare the ledger.)

Question 16

Palmerston Freight wrote off a bad debt of $990 (including GST) against its Allowance for Doubtful Debts. State the amount by which GST Clearing is adjusted, and explain why the business is entitled to reverse the GST originally recorded on the sale.

Question 17

At 30 June 2025 Quarry Hill Supplies carried Accounts Receivable of $31 900 and an Allowance for Doubtful Debts of $1 300. On 8 October 2025 a customer's debt of $880 (including GST) was written off (Memo 21). Prepare the Balance Sheet extract for the current assets Accounts Receivable and Allowance for Doubtful Debts immediately after the write-off.

Question 18

At 30 June 2025 Riverside Building Co carried Accounts Receivable of $40 000 and an Allowance for Doubtful Debts of $1 200. During the year ended 30 June 2026 it wrote off $550 (including GST) on 16 August 2025 (Memo 12) and $440 (including GST) on 3 February 2026 (Memo 26). Net credit sales for the year were $55 000; 2% is estimated to be doubtful. Prepare the Allowance for Doubtful Debts ledger account for the year, and state the net Accounts Receivable reported in the Balance Sheet as at 30 June 2026.

Answers

1.
    b. GST reversed $40 c. Allowance $400
2.
    b. Accounts Receivable $17 670 c. Net Accounts Receivable $17 370
3.
    c. Balance day adjustment $600 (allowance $900 at 30 June 2026)
4.
    b. Total assets decrease $50; total liabilities decrease $50 c. Faithful representation (see solutions)
5.
    b. Allowance $350 c. See solutions
6.
    b. $100 debit balance c. Allowance $600
7. Allowance $250 (GST reversed $70)
8. Accounts Receivable $25 300; net Accounts Receivable $25 200
9. Allowance $200
10. Allowance $1 180 (balance day adjustment $880)
11. $250 debit balance before the adjustment; allowance $800 after it
12. See solutions
13. See solutions
14. Relevance and faithful representation (see solutions)
15. Balance day adjustment $800
16. GST Clearing debited $90 (see solutions)
17. Net Accounts Receivable $30 520
18. Allowance $1 400; net Accounts Receivable $37 610

Fully-worked solutions

Question 1

Date 2025	Details	Debit $	Credit $
3 Sep	Allowance for Doubtful Debts	400	
	GST Clearing	40	
	Accounts Receivable		440
	Bad debt written off against the allowance (Memo 15)		

b. GST reversed = 1/11 × $440 = **$40**. GST Clearing is debited because the GST on the original sale will never be collected from the customer, so the business reverses (reduces) the GST liability it recorded when the sale was made.

c. Allowance = $800 − $400 = **$400** (the $400 GST-exclusive amount is drawn from the allowance).

Question 2

Date 2025	Details	Debit $	Credit $
11 Oct	Allowance for Doubtful Debts	300	
	GST Clearing	30	

Date 2025	Details	Debit $	Credit $
	Accounts Receivable		330
	Bad debt written off against the allowance (Memo 22)		

b. Accounts Receivable = $18 000 − $330 = **$17 670**.

c. Allowance = $600 − $300 = $300, so net Accounts Receivable = $17 670 − $300 = **$17 370**.

Question 3

Date 2025	Details	Debit $	Credit $
7 Dec	Allowance for Doubtful Debts	200	
	GST Clearing	20	
	Accounts Receivable		220
	Bad debt written off against the allowance (Memo 31)		

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	600	
	Allowance for Doubtful Debts		600
	Allowance topped up to 2% of net credit sales at balance day		

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2025			2025		
7 Dec	Accounts Receivable	200	1 Jul	Balance	500
2026			2026		
30 Jun	Balance c/d	900	30 Jun	Bad and Doubtful Debts	600
		1 100			1 100
			1 Jul	Balance b/d	900

c. Balance day adjustment = 2% × $30 000 = **$600**.

Question 4

Date 2025	Details	Debit $	Credit $
18 Sep	Allowance for Doubtful Debts	500	
	GST Clearing	50	

Date 2025	Details	Debit $	Credit $
	Accounts Receivable		550
	Bad debt written off against the allowance (Memo 9)		

b. GST = 1/11 × $550 = $50, so $500 (GST-exclusive) is drawn from the allowance. Accounts Receivable (an asset) falls by the full $550. Debiting the **Allowance for Doubtful Debts** $500 reduces a **contra-asset**, which lowers the amount deducted from Accounts Receivable and so *raises* net assets by $500. **Total assets therefore decrease by $550 − $500 = $50.** Debiting GST Clearing $50 reduces the GST owed to the ATO, so **total liabilities decrease by $50**. Owner's equity is unchanged, because the write-off records no expense, so the accounting equation still holds (assets −$50 = liabilities −$50 + owner's equity $0).

c. **Faithful representation** (supported by **relevance**): deducting the allowance stops Accounts Receivable being **overstated**, so the asset is reported completely and without bias at the amount the business realistically expects to collect — information that is also more relevant to users' decisions.

Question 5

Date 2025	Details	Debit $	Credit $
25 Nov	Allowance for Doubtful Debts	300	
	GST Clearing	30	
	Accounts Receivable		330
	Bad debt written off against the allowance (Memo 14)		

b. GST = 1/11 × $330 = $30, so the GST-exclusive amount debited to the allowance is $300. Allowance = $650 − $300 = **$350 credit**.

c. A **debit balance** means the debts actually written off have **exceeded the allowance set aside for them**, so the **previous estimate of doubtful debts was too low** — the business underestimated the bad debts arising from the earlier period's credit sales. The account is not left overdrawn: at the next balance day the business estimates the doubtful debts on **that year's** net credit sales and records the balance day adjustment (Dr Bad and Doubtful Debts; Cr Allowance for Doubtful Debts), and that credit **re-establishes a credit balance** in the allowance.

Question 6

Date 2025	Details	Debit $	Credit $
14 Aug	Allowance for Doubtful Debts	200	
	GST Clearing	20	
	Accounts Receivable		220
	Bad debt written off against the allowance (Memo 6)		

Date 2026	Details	Debit $	Credit $
2 Mar	Allowance for Doubtful Debts	300	
	GST Clearing	30	
	Accounts Receivable		330
	Bad debt written off against the allowance (Memo 19)		

b. Write-offs total $200 + $300 = $500 (GST-exclusive), against an opening allowance of $400, so the account is **$100 debit** (overdrawn) immediately before the balance day adjustment.

c. Balance day adjustment = 2% × $35 000 = $700, so the allowance = −$100 + $700 = **$600** credit.

Question 7

Date 2025	Details	Debit $	Credit $
12 Sep	Allowance for Doubtful Debts	700	
	GST Clearing	70	
	Accounts Receivable		770
	Bad debt written off against the allowance (Memo 24)		

GST reversed = 1/11 × $770 = $70; $700 is drawn from the allowance. Allowance = $950 − $700 = **$250**.

Question 8

Date 2025	Details	Debit $	Credit $
4 Nov	Allowance for Doubtful Debts	1 000	
	GST Clearing	100	
	Accounts Receivable		1 100
	Bad debt written off against the allowance (Memo 40)		

GST reversed = 1/11 × $1 100 = $100. Accounts Receivable = $26 400 − $1 100 = **$25 300**; allowance = $1 100 − $1 000 = $100, so net Accounts Receivable = $25 300 − $100 = **$25 200**.

Question 9

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2025			2025		
19 Aug	Accounts Receivable	400	1 Jul	Balance	1 200

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2026					
6 Jan	Accounts Receivable	600			
30 Jun	Balance c/d	200			
		1 200			1 200
			1 Jul	Balance b/d	200

The two write-offs draw $400 and $600 (GST-exclusive) from the allowance, so the balance after them is $1 200 − $400 − $600 = **$200**.

Question 10

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2025			2025		
30 Oct	Accounts Receivable	300	1 Jul	Balance	600
2026			2026		
30 Jun	Balance c/d	1 180	30 Jun	Bad and Doubtful Debts	880
		1 480			1 480
			1 Jul	Balance b/d	1 180

The write-off draws $300 from the allowance; the balance day adjustment = 2% × $44 000 = $880 tops it up to $600 − $300 + $880 = **$1 180**.

Question 11

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2025			2025		
21 Sep	Accounts Receivable	500	1 Jul	Balance	450
2026			2026		
17 Apr	Accounts Receivable	200	30 Jun	Bad and Doubtful Debts	1 050
30 Jun	Balance c/d	800			
		1 500			1 500
			1 Jul	Balance b/d	800

Write-offs total $500 + $200 = $700 against an opening allowance of $450, so immediately before the balance day adjustment the allowance is **$250 debit** (overdrawn). The adjustment = 2.5% × $42 000 = $1 050 re-establishes a credit balance of −$250 + $1 050 = **$800**.

Question 12

The Bad and Doubtful Debts expense of this business was recognised **at the balance day when the Allowance for Doubtful Debts was raised** — in the period the credit sales that created the debts were earned, applying the **accrual basis** assumption. The $660 write-off simply removes an actual bad debt by debiting the Allowance for Doubtful Debts ($600, a contra-asset), debiting GST Clearing ($60) and crediting Accounts Receivable ($660); no expense account is affected. Reporting the write-off as an expense would **double-count** a cost that has already been recognised and would understate profit in the later period, so it does not appear in the Income Statement.

Question 13

Under the **direct write-off method**, no allowance is created and a Bad Debts expense is recognised only when a specific debt is judged uncollectable; the expense therefore falls in the period of the write-off, which is often **later than the sale**, and Accounts Receivable remains **overstated** until then. Under the **allowance method**, expected bad debts are estimated at balance day and an allowance is raised as the expense, so the expense is **matched to the period of the sale** (accrual basis) and Accounts Receivable is reported at **net realisable value**; a later write-off creates no new expense. The study design **requires the allowance method**.

Question 14

A business creates an Allowance for Doubtful Debts and reports Accounts Receivable net of it for two reasons:

- **Relevance** — the net figure shows the amount the business **realistically expects to collect**, which is more useful to users making decisions than the gross amount owing.
- **Faithful representation** — without the allowance, Accounts Receivable (and profit, through the expense) would be **overstated**; deducting the allowance reports the asset completely, neutrally and free from bias.

(The timing of the expense also reflects the **accrual basis** assumption, matching the expense to the period in which the credit-sales revenue was earned.)

Question 15

Account reconstruction of the Allowance for Doubtful Debts:

- Opening balance (credit) = $900.
- Write-off during the year = $440 − (1/11 × $440) = $440 − $40 = $400 (GST-exclusive), a debit to the allowance, leaving $900 − $400 = $500.
- Closing balance (credit) = $1 300.

Balance day adjustment = closing balance − balance before the adjustment = $1 300 − $500 = **$800** (Dr Bad and Doubtful Debts; Cr Allowance for Doubtful Debts $800).

Question 16

GST Clearing is debited by 1/11 × $990 = **$90**. When the original credit sale was made, the business **credited GST Clearing** with the GST it charged the customer, increasing the GST it owed the ATO even though no cash had been received. Because the debt is now bad, that GST will **never be collected**, so the business is entitled to a **decreasing adjustment**: debiting GST Clearing $90 reverses the GST recorded on the sale and reduces the amount owed to (or increases the refund due from) the ATO.

Question 17

The write-off draws 1/11 × $880 = $80 from GST Clearing and $800 from the allowance, so Accounts Receivable = $31 900 − $880 = $31 020 and the allowance = $1 300 − $800 = $500.

Balance Sheet (extract) as at 8 October 2025

Current Assets	$	$
Accounts Receivable	31 020	
less Allowance for Doubtful Debts	500	30 520

∴ net Accounts Receivable is reported at **$30 520**.

Question 18

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2025			2025		
16 Aug	Accounts Receivable	500	1 Jul	Balance	1 200
2026			2026		
3 Feb	Accounts Receivable	400	30 Jun	Bad and Doubtful Debts	1 100
30 Jun	Balance c/d	1 400			
		2 300			2 300
			1 Jul	Balance b/d	1 400

The two write-offs draw \$500 and \$400 (GST-exclusive) from the allowance; the balance day adjustment = 2% × \$55 000 = \$1 100 tops it up to \$1 200 − \$500 − \$400 + \$1 100 = **\$1 400**. Accounts Receivable = \$40 000 − \$550 − \$440 = \$39 010, so net Accounts Receivable = \$39 010 − \$1 400 = **\$37 610**.

Topic 4 Test A — Recording and analysis

Reading time: 10 minutes · Writing time: 50 minutes · 50 marks · A scientific calculator may be used.

This test is cumulative over Chapters 10–12 (reporting for profit, reporting for cash, and the allowance for doubtful debts). Show all working. Report titles and classifications carry marks.

Question 1 (13 marks)

Marradale Trading is a retailer that reports annually to 30 June. The following balances are taken from its ledger for the year ended 30 June 2026 (**Memo 60**). Every account listed is either a revenue or an expense; the business's assets, liabilities and owner's-equity accounts have been excluded.

Account	$
Sales	315 000
Sales Returns	15 000
Cost of Sales	172 000
Cartage Inwards	8 000
Inventory Loss	3 000
Discount Revenue	3 000
Advertising	10 000
Cartage outwards	5 000
Sales wages	22 000
Office wages	18 000
Rent expense	11 000
Insurance	3 000
Interest expense	4 000
Discount expense	2 000

a. Prepare a fully classified Income Statement for the year ended 30 June 2026, grouping Other Expenses as selling, administrative and finance expenses. 8 marks

b. Calculate the Gross Profit Margin and the Net Profit Margin for the year ended 30 June 2026. 2 marks

c. In the year ended 30 June 2025 Marradale's Gross Profit Margin was 40.0% and its Net Profit Margin was 18.0%. Referring to **both** margins, explain whether the change in profitability from 2025 to 2026 arose in cost of sales or in other expenses. 3 marks

Question 2 (11 marks)

Kinsford Timber & Hardware began the year ended 30 June 2026 with a Bank balance of $14 000. Its cash records for the year were: cash sales $210 000; receipts from Accounts Receivable $96 000; payments to Accounts Payable $150 000; wages $52 000; GST paid to the ATO $18 000; interest paid $6 000; purchase of a forklift $70 000; proceeds from the sale of a delivery truck $15 000; a capital contribution $25 000; a loan received from Aldergrove Finance $30 000; and drawings $28 000.

a. Prepare the classified Cash Flow Statement for the year ended 30 June 2026, and state the Bank balance at the end of the year. 7 marks

b. Explain how the $70 000 purchase of the forklift was funded. 2 marks

c. Kinsford's current liabilities were $16 000 at 1 July 2025 and $24 000 at 30 June 2026. Calculate the Cash Flow Cover and interpret it in one sentence. 2 marks

Question 3 (10 marks)

Tarnbrook Wholesale reports annually to 30 June. During the year ended 30 June 2026 its credit sales were $264 000 and its credit sales returns were $24 000. From past experience it estimates that **2.5%** of net credit sales will prove doubtful. At 30 June 2026 its current assets are Bank $10 000, Accounts Receivable $88 000 and Inventory $22 000.

a. Calculate the net credit sales, and record the balance day adjustment that creates the Allowance for Doubtful Debts in the General Journal. 3 marks

b. Prepare the Current Assets extract of the Balance Sheet as at 30 June 2026, showing Accounts Receivable net of the allowance. 3 marks

c. On 5 August 2026 a customer, *Aldervale Cafe*, was declared bankrupt and its debt of $990 (including GST) was written off as bad (**Memo 44**). Record the write-off in the General Journal, and state the balance of the Allowance for Doubtful Debts immediately afterwards. 2 marks

d. Explain why the bad debt written off in part **c** does **not** create a new expense in the Income Statement. Refer to the accrual basis. 2 marks

Question 4 (9 marks)

Wexford Furnishings reported a Net Profit of $68 000 for the year ended 30 June 2026, yet its owner reports that the business is "struggling to pay its suppliers". Its Cash Flow Statement for the year reported **Net Cash Flows from Operating Activities of $46 000**. During the year: depreciation was $12 000; Accounts Receivable increased by $22 000; Inventory increased by $18 000; and Accounts Payable increased by $6 000. The business also paid $20 000 cash for new equipment, the owner withdrew $36 000, and $15 000 of a loan was repaid. The Bank balance at the start of the year was $30 000.

a. Referring to **two** of the items listed above, explain why the Net Cash Flows from Operating Activities of $46 000 differ from the Net Profit of $68 000. 4 marks

b. Calculate the overall change in the Bank balance and the Bank balance at the end of the year. 2 marks

c. Discuss why the Bank balance fell despite the $68 000 Net Profit, referring to the cash flows **outside** operating activities, and suggest **two** strategies that would improve Wexford's cash position. 3 marks

Question 5 (7 marks)

Ellandale Retail reports Net Sales of $400 000, a Gross Profit of $160 000 and a Net Profit of $40 000 for the year ended 30 June 2026 (the business had no other revenue and no inventory adjustment). The owner is considering a marketing campaign for the coming year that is expected to lift Net Sales by $100 000 while holding the Gross Profit Margin unchanged; the campaign and its related selling costs would raise the business's other expenses by $16 000.

a. Calculate the Gross Profit Margin and the Net Profit Margin for the year ended 30 June 2026. 2 marks

b. Assuming the campaign performs as expected, **model** its effect by calculating the projected Gross Profit, Net Profit and Net Profit Margin for the coming year. 3 marks

c. Explain, using your figures, whether the campaign would improve the business's profitability. 2 marks

Topic 4 Test A — solutions

Question 1

Income Statement for the year ended 30 June 2026	$	$
Revenue		
Sales	315 000	
less Sales Returns	15 000	
Net Sales		**300 000**
less **Cost of Goods Sold**		
Cost of Sales	172 000	
add Cartage Inwards	8 000	
Cost of Goods Sold		**180 000**
Gross Profit		**120 000**
less Inventory Loss		3 000
Adjusted Gross Profit		**117 000**
add Discount Revenue		3 000
		120 000
less **Other Expenses**		
Selling expenses		
Advertising	10 000	
Cartage outwards	5 000	
Sales wages	22 000	
Administrative expenses		
Office wages	18 000	
Rent expense	11 000	
Insurance	3 000	
Finance expenses		
Interest expense	4 000	
Discount expense	2 000	
Total Other Expenses		**75 000**
Net Profit		**45 000**

b. Gross Profit Margin = $120 000 ÷ $300 000 × 100 = **40.0%**; Net Profit Margin = $45 000 ÷ $300 000 × 100 = **15.0%**.

c. The **Gross Profit Margin was unchanged** at 40.0%, so the business's control of its cost of sales — its buying prices and its mark-up — held steady between 2025 and 2026. The **Net Profit Margin fell** from 18.0% to 15.0%, a fall of 3 percentage points. Because the fall occurred **below** the Gross Profit line while the gross margin was steady, the deterioration arose in **other expenses**, which grew faster than net sales (rising from 22% to 25% of net sales). This is an **expense-control** problem, not a cost-of-sales problem.

Question 2

Cash Flow Statement for the year ended 30 June 2026	$	$
Operating Activities		
Cash sales	210 000	

Cash Flow Statement for the year ended 30 June 2026	$	$
Receipts from Accounts Receivable	96 000	
Payments to Accounts Payable	(150 000)	
Wages	(52 000)	
GST paid	(18 000)	
Interest expense	(6 000)	
Net Cash Flows from Operating Activities		**80 000**
Investing Activities		
Purchase of forklift	(70 000)	
Proceeds from sale of delivery truck	15 000	
Net Cash Flows from Investing Activities		**(55 000)**
Financing Activities		
Capital contribution	25 000	
Loan – Aldergrove Finance	30 000	
Drawings	(28 000)	
Net Cash Flows from Financing Activities		**27 000**
Net Increase in Cash		**52 000**
add Bank balance at start (1 July 2025)		14 000
Bank balance at end (30 June 2026)		**66 000**

Net change = $80 000 − $55 000 + $27 000 = **$52 000 increase**; Bank at end = $14 000 + $52 000 = **$66 000**.

b. The $70 000 forklift was funded partly by the **$15 000 proceeds from selling the old delivery truck** (also an investing flow) and the remaining **$55 000 from operating cash**. Operating activities generated **$80 000**, comfortably more than the $55 000 net investing outflow, so the whole forklift purchase was covered from the business's own trading and asset sale — no new borrowing was needed to fund it (the $30 000 loan and $25 000 capital contribution instead helped lift the Bank balance and cover drawings).

c. Average current liabilities = ($16 000 + $24 000) ÷ 2 = $20 000; Cash Flow Cover = $80 000 ÷ $20 000 = **4.0 times** — Kinsford's operating cash was four times its average current liabilities, so one year's operating cash could cover its short-term debts four times over, a very strong short-term cash position.

Question 3

a. Net credit sales = $264 000 − $24 000 = **$240 000**; Allowance = 2.5% × $240 000 = **$6 000**.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	6 000	
	Allowance for Doubtful		6 000

Date 2026	Details	Debit $	Credit $
	Debts		
	Allowance for doubtful debts created (2.5% of net credit sales $240 000)		

b. Net Accounts Receivable = $88 000 − $6 000 = $82 000; Total Current Assets = $10 000 + $82 000 + $22 000 = $114 000.

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Bank		10 000
Accounts Receivable	88 000	
less Allowance for Doubtful Debts	6 000	82 000
Inventory		22 000
Total Current Assets		**114 000**

c. GST reversed = 1/11 × $990 = $90; GST-exclusive amount drawn from the allowance = $990 − $90 = $900.

General Journal

Date 2026	Details	Debit $	Credit $
5 Aug	Allowance for Doubtful Debts	900	
	GST Clearing	90	
	Accounts Receivable		990
	Bad debt of Aldervale Cafe written off against the allowance (Memo 44)		

The Allowance for Doubtful Debts falls to $6 000 − $900 = **$5 100 Cr**.

d. The **Bad and Doubtful Debts expense was already recognised** at 30 June 2026, when the allowance was created — in the same period as the credit sales that produced the debts, applying the **accrual basis** (matching the expense of selling on credit to the revenue that created it). The allowance was set aside precisely to absorb debts that later prove bad, so the write-off merely **reduces the Allowance for Doubtful Debts** (a contra-asset), **reduces Accounts Receivable** (an asset) and **reverses the GST** — no expense account is touched. Recording an expense again on write-off would **double-count** the same cost and understate profit in the later period.

Question 4

a. Net Profit is measured on the **accrual basis** — revenues *earned* less expenses *incurred* — while Net Cash Flows from Operating Activities counts only the cash actually *received and paid* in day-to-day trading, so the two figures differ by **$22 000** ($68 000 − $46 000). Two items that explain the gap:

- **Accounts Receivable increased by $22 000.** Credit sales are recorded as **Sales revenue** as soon as the inventory is sold, so they lift Net Profit immediately; but the cash is not received until the debtor pays. A $22 000 *rise* in Accounts Receivable means the business earned $22 000 more revenue than it collected in cash, so operating cash is **lower** than profit by that amount.
- **Inventory increased by $18 000.** Cash was paid to suppliers for $18 000 of inventory that was **not sold** during the year, so it never became Cost of Sales. The cash left the business (reducing operating cash) without reducing Net Profit, again pushing operating cash **below** profit.

(The other two items work the **opposite** way: **depreciation of $12 000** is a **non-cash expense** — it reduces profit but no cash is paid — and the **$6 000 increase in Accounts Payable** means $6 000 of expenses were incurred but not yet paid, so cash out was $6 000 less than profit assumed. Together they add back $18 000, leaving the net gap of $22 000.)

Change in the Bank balance — Wexford Furnishings	$
Net Cash Flows from Operating Activities	46 000
Net Cash Flows from Investing Activities (payment for equipment)	(20 000)
Net Cash Flows from Financing Activities (drawings $36 000 + loan repayment $15 000)	(51 000)
Net decrease in cash	**(25 000)**
add Bank balance at start (1 July 2025)	30 000
Bank balance at end (30 June 2026)	**5 000**

Net change = $46 000 − $20 000 − $51 000 = **$25 000 decrease**; the Bank balance fell from $30 000 to **$5 000**.

c. The $46 000 generated by operating activities was **more than consumed by the cash flows outside operating activities**: $20 000 was paid for new equipment (an **investing** outflow), the owner withdrew $36 000 and $15 000 of the loan was repaid (both **financing** outflows) — **$71 000** in all, against $46 000 coming in. **None of those three payments is an expense**, so none of them reduced the $68 000 Net Profit, yet together they drained $71 000 of cash and left just $5 000 in the Bank. This is the classic **profitable-but-cash-poor** position: profit measures trading performance on the accrual basis, not the cash a business has left. Two strategies that would improve the cash position: (i) **moderate the owner's drawings** — at $36 000 they alone exceeded the $25 000 fall in the Bank, and cutting them retains cash in the business without affecting profit; and (ii) **finance major asset purchases by loan or lease rather than paying cash**, spreading the $20 000 outlay over the asset's useful life instead of meeting it in a single year. (Wexford could also **tighten credit terms** to collect from Accounts Receivable faster and **reduce inventory to match demand**, freeing the cash currently tied up in those two assets.)

Question 5

a. Gross Profit Margin = $160 000 ÷ $400 000 × 100 = **40.0%**; Net Profit Margin = $40 000 ÷ $400 000 × 100 = **10.0%**.

b. Current other expenses = Gross Profit $160 000 − Net Profit $40 000 = $120 000. Projected Net Sales = $400 000 + $100 000 = $500 000.

- Projected **Gross Profit** = 40.0% × $500 000 = **$200 000** (the Gross Profit Margin is held at 40.0%).
- Projected other expenses = $120 000 + $16 000 = $136 000, so projected **Net Profit** = $200 000 − $136 000 = **$64 000**.
- Projected **Net Profit Margin** = $64 000 ÷ $500 000 × 100 = **12.8%**.

c. The campaign would **improve profitability**. Even though it adds $16 000 to other expenses, it lifts the Net Profit Margin from **10.0% to 12.8%** — the business would keep 12.8 cents of net profit in every sales dollar instead of 10.0 cents. This works because gross profit grows in step with the higher sales (the Gross Profit Margin is unchanged at 40.0%), while the extra $16 000 of other expenses grows far more slowly than the $100 000 rise in net sales, so a larger proportion of each sales dollar survives as net profit.

Topic 4 Test B — Short-answer recording

Reading time: 10 minutes · Writing time: 45 minutes · 40 marks · A scientific calculator may be used.

This test is cumulative over Chapters 10–12. Show all working. General Journal narrations are required where an entry is asked for.

Question 1 (8 marks)

Halloway Traders balances its books on 30 June 2026. Its pre-closing Trial Balance shows the following revenue and expense balances (**Memo 70**): Sales $220 000; Discount Revenue $3 000; Sales Returns $8 000; Cost of Sales $120 000; Wages $44 000; Rent expense $15 000; Advertising $6 000; Interest expense $4 000.

a. Record the two General Journal entries to close the revenue accounts and the expense accounts to the Profit and Loss Summary account. 4 marks

b. Post both entries to the Profit and Loss Summary account and state the net profit for the year. 3 marks

c. State whether the Profit and Loss Summary has a debit or a credit balance, and what that balance represents. 1 mark

Question 2 (6 marks)

Nunerong Interiors (owner: P. Ashby) is closing its ledger for the year ended 30 June 2026. Its net profit for the year was $32 000. Capital stood at $95 000 on 1 July 2025, and the owner's drawings for the year were $38 000 (cash $34 000 taken on 31 December 2025 and inventory $4 000 taken on 30 June 2026).

a. Record the General Journal entries to transfer the net profit and the drawings to the Capital account. 2 marks

b. Prepare the Capital account for the year, balanced as at 30 June 2026. 3 marks

c. State the closing balance of Capital at 30 June 2026. 1 mark

Question 3 (8 marks)

At 1 July 2025 *Cranleigh Supplies* carried an Allowance for Doubtful Debts of $1 400. During the year ended 30 June 2026 two debts became irrecoverable and were written off: $660 (including GST) owed by *Fernbrook Cafe* on 12 September 2025 (**Memo 8**), and $440 (including GST) owed by *Oakmont Catering* on 20 February 2026 (**Memo 19**). Net credit sales for the year ended 30 June 2026 were $90 000, and the business estimates that **2%** of net credit sales will prove doubtful.

a. Record the two write-offs in the General Journal. 3 marks

b. Record the balance day adjustment for the Allowance for Doubtful Debts at 30 June 2026 in the General Journal. 2 marks

c. Prepare the Allowance for Doubtful Debts ledger account for the year, balanced as at 30 June 2026. 3 marks

Question 4 (7 marks)

Bellmont Hardware is preparing its Cash Flow Statement for the year ended 30 June 2026.

a. State, for each of the following items, the activity (Operating, Investing or Financing) and whether it is an inflow or an outflow: (i) cash sales; (ii) purchase of a delivery van; (iii) receipts from Accounts Receivable; (iv) repayment of loan principal; (v) interest paid; (vi) a capital contribution by the owner; (vii) proceeds from the sale of old equipment; (viii) GST paid to the ATO. 4 marks

b. From the following operating cash records, prepare the Operating Activities section of the Cash Flow Statement and state the Net Cash Flows from Operating Activities: cash sales $120 000; receipts from Accounts Receivable $44 000; payments to Accounts Payable $88 000; wages $24 000; GST paid $8 000; interest paid $2 000. 3 marks

Question 5 (6 marks)

At 30 June 2026, after its revenue and expense accounts had been closed to it, the Profit and Loss Summary account of *Pinewood Cycles* had been credited with **Sales** of $140 000 and debited with **Sundry expenses** of $152 000 (Cost of Sales $88 000, Wages $42 000, Rent expense $14 000 and Interest expense $8 000).

a. Calculate the net loss for the year. 1 mark

b. Record the General Journal entry to transfer the net loss to the Capital account. 2 marks

c. Complete the Profit and Loss Summary account, showing it fully balanced. 3 marks

Question 6 (5 marks)

Ravensworth Distributors reports annually to 30 June. Its Allowance for Doubtful Debts stood at $3 000 on 1 July 2025, and bad debts of $2 200 (GST-exclusive) were written off against the allowance during the year ended 30 June 2026. Net credit sales for that year were $160 000, and the business estimates that **2.5%** of net credit sales will prove doubtful. Accounts Receivable at 30 June 2026 is $62 000.

a. Calculate the Bad and Doubtful Debts expense for the year ended 30 June 2026 and prepare the Income Statement extract reporting it. 2 marks

b. Calculate the balance of the Allowance for Doubtful Debts at 30 June 2026, and prepare the Balance Sheet extract as at that date showing Accounts Receivable net of the allowance. 3 marks

Topic 4 Test B — solutions

Question 1

a. **Sales Returns** is a *contra-revenue*, so despite its debit balance it is closed **inside the revenue-closing entry** (by a credit), not with the expenses: net revenue credited to the Profit and Loss Summary = $220 000 + $3 000 − $8 000 = $215 000. Total expenses = $120 000 + $44 000 + $15 000 + $6 000 + $4 000 = $189 000.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Sales	220 000	
	Discount Revenue	3 000	
	Sales Returns		8 000
	Profit and Loss Summary		215 000
	Closing the revenue accounts to the Profit and Loss Summary account (Memo 70)		
30 Jun	Profit and Loss Summary	189 000	
	Cost of Sales		120 000
	Wages		44 000
	Rent expense		15 000
	Advertising		6 000
	Interest expense		4 000
	Closing the expense accounts to the Profit and Loss Summary account (Memo 70)		

Profit and Loss Summary

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Sundry expenses	189 000	30 Jun	Sundry revenues	215 000

Net profit = $215 000 − $189 000 = **$26 000**.

c. The Profit and Loss Summary has a **credit balance** of $26 000; this balance represents the **net profit** for the year (revenue credited exceeds expenses debited), which is transferred to the owner's Capital account.

Question 2

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Profit and Loss Summary	32 000	
	Capital		32 000
	Net profit transferred to the Capital account		
30 Jun	Capital	38 000	
	Drawings		38 000

Date 2026	Details	Debit $	Credit $
	Drawings for the year transferred to the Capital account		

Capital

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun 2026	Drawings	38 000	1 Jul 2025	Balance b/d	95 000
30 Jun 2026	Balance c/d	89 000	30 Jun 2026	Profit and Loss Summary	32 000
		127 000			**127 000**
			1 Jul 2026	Balance b/d	89 000

c. Closing Capital = $95 000 + $32 000 − $38 000 = **$89 000 Cr**.

Question 3

a. Write-off 1 (Fernbrook Cafe): GST = 1/11 × $660 = $60; GST-exclusive = $600. Write-off 2 (Oakmont Catering): GST = 1/11 × $440 = $40; GST-exclusive = $400.

General Journal

Date 2025	Details	Debit $	Credit $
12 Sep	Allowance for Doubtful Debts	600	
	GST Clearing	60	
	Accounts Receivable		660
	Bad debt of Fernbrook Cafe written off against the allowance (Memo 8)		

Date 2026	Details	Debit $	Credit $
20 Feb	Allowance for Doubtful Debts	400	
	GST Clearing	40	
	Accounts Receivable		440
	Bad debt of Oakmont Catering written off against the allowance (Memo 19)		

b. Balance day adjustment = 2% × $90 000 = $1 800.

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Bad and Doubtful Debts	1 800	
	Allowance for Doubtful Debts		1 800
	Balance day adjustment for doubtful debts (2% of net credit sales $90 000)		

Allowance for Doubtful Debts

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
2025			2025		
Sep 12	Accounts Receivable	600	Jul 1	Balance	1 400
2026			2026		
Feb 20	Accounts Receivable	400	Jun 30	Bad and Doubtful Debts	1 800
Jun 30	Balance c/d	2 200			
		3 200			**3 200**
			Jul 1	Balance b/d	2 200

The two write-offs draw $600 and $400 (GST-exclusive) from the allowance, reducing it to $400; the $1 800 balance day adjustment — 2% of net credit sales under the **Income-Statement approach**, calculated independently of the balance already in the account — then raises it to **$2 200 Cr**.

Question 4

a.
   (i) **Operating inflow**; (ii) **Investing outflow**; (iii) **Operating inflow**; (iv) **Financing outflow**; (v) **Operating outflow**; (vi) **Financing inflow**; (vii) **Investing inflow**; (viii) **Operating outflow**.

b. Net Cash Flows from Operating = ($120 000 + $44 000) − ($88 000 + $24 000 + $8 000 + $2 000) = $164 000 − $122 000 = **$42 000**.

Cash Flow Statement (extract)

Cash Flow Statement (extract) for the year ended 30 June 2026	$	$
Operating Activities		
Cash sales	120 000	
Receipts from Accounts Receivable	44 000	
Payments to Accounts Payable	(88 000)	
Wages	(24 000)	
GST paid	(8 000)	
Interest expense	(2 000)	
Net Cash Flows from Operating Activities		**42 000**

Question 5

a. Net loss = expenses $152 000 − Sales $140 000 = **$12 000** (expenses exceed revenue, so the account has a debit balance).

General Journal

Date 2026	Details	Debit $	Credit $
30 Jun	Capital	12 000	
	Profit and Loss Summary		12 000
	Net loss transferred to the Capital account		

Profit and Loss Summary

Date	Cross-reference	Amount $	Date	Cross-reference	Amount $
30 Jun	Sundry expenses	152 000	30 Jun	Sales	140 000
			30 Jun	Capital	12 000
		152 000			**152 000**

The single expense-closing entry produces **one** posting on the debit side — *Sundry expenses* $152 000 — not one posting per expense account. The $12 000 net loss appears as the *Capital* entry on the **credit** side, closing the account at $152 000 on both sides.

Question 6

a. Under the **Income-Statement approach** the expense *is* the estimate for the current year: Bad and Doubtful Debts = 2.5% × $160 000 = **$4 000**. The $2 200 written off during the year was charged against the **allowance**, not to expense — it had already been recognised as an expense in an earlier period — so it does not alter this year's figure.

Income Statement (extract)

Income Statement (extract) for the year ended 30 June 2026	$
Other Expenses	
Bad and Doubtful Debts	4 000

b. Allowance for Doubtful Debts at 30 June 2026 = $3 000 − $2 200 + $4 000 = **$4 800 Cr**; net Accounts Receivable = $62 000 − $4 800 = $57 200.

Balance Sheet (extract)

Balance Sheet (extract) as at 30 June 2026	$	$
Current Assets		
Accounts Receivable	62 000	
less Allowance for Doubtful Debts	4 800	**57 200**

The expense ($4 000) and the closing allowance ($4 800) differ because $800 of the opening $3 000 estimate was **not** consumed by the year's write-offs and remains in the account alongside the new $4 000 estimate.