DEALING WITH DEBTORS

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This article sets out the accounting treatment for the impairment of trade receivables/debtors. The provision for bad debts is now, in effect, governed by IAS 39, Financial Instruments: Recognition and Measurement for International stream students or FRS 26, Financial Instruments: Measurement for UK stream students. Adapted papers generally follow the content of IAS 39.
This article covers the general accounting principles and then outlines its applicability to CAT Scheme Papers 1, 3 and 6, and Professional Scheme Paper F3.

GENERAL ACCOUNTING PRINCIPLES (RELEVANT TO ACCA QUALIFICATION PAPERS F7 AND P2)

Trade receivables are financial assets falling under 'loans and receivables' in IAS 39 and FRS 26. According to these standards, loans and receivables are measured at amortised cost using the effective interest rate method. Initially, they will be carried at fair value at the time of recognition, which in the case of trade receivables/debtors will be the invoiced amount.

The effective interest rate method spreads the interest income or expense over the life of the financial asset or liability. Obviously, such a method does not seem to be relevant to trade receivables/debtors where normally there is no interest payment to spread. FRS 26 and IAS 39 therefore allow short-term receivables/debtors with no stated interest rate to be measured at the original invoice amount, if the effect of discounting is immaterial. This would apply to trade receivables/debtors and therefore, they will still be carried at the invoice amount.

However, FRS 26 and IAS 39 state that an entity must assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If there is objective evidence that an impairment loss on the financial assets has been incurred, the loss must be recognised in profit or loss. Since trade receivables/debtors are financial assets, annual impairment assessments must be performed.

The amount of the loss is determined by looking at the carrying value of the trade receivable/debtor and comparing it with the present value of the estimated cash flows discounted at the effective interest rate. As previously outlined, trade receivables will not normally be discounted and will not normally have an effective interest rate.

IAS 39 and FRS 26 detail a quite specific methodology for calculating an impairment loss. The use of old provisioning matrices such as age analysis and general provisions may not produce the correct answer under IAS 39.

The implications are, for example, that if an entity applies a flat percentage of 50% of receivables in 90 days, and 100% of receivables/debtors in 120 or more days for example, in order to estimate the impairment loss, this will not comply with the requirements of IAS 39/FRS 26. This will only be acceptable if the formula can be shown to produce an estimate sufficiently close to the method specified in IAS 39/FRS 26 which requires an estimate of the cash which will actually be received.

Impairment of individually significant balances must be separately assessed and an allowance made when it is probable that the cash due will not be received in full.

Impairment of individually non-significant balances can be measured on a portfolio or group basis. Any receivables that are not thought to be impaired are included in the group assessment.

If information becomes available that identifies losses on a receivable in the group then it is removed and individually assessed.

The collective assessment of impairment requires the splitting of the list of receivables into groups of trade receivables that share similar credit risk characteristics. The credit risk groups are to be assessed for impairment using historical loss experience for each group. Such historical loss experience would be adjusted to reflect the effects of current conditions.

An individual receivable/debtor impairment factor is likely to be specific to that receivable/debtor - pending liquidation of the entity, for example.

A collective impairment factor is likely to be as a result of past economic events that affect the receivables in general (eg interest rates). Impairment losses will be recognised only when they are incurred. Thus, if there is deterioration in the credit quality of the financial assets as a result of a past event, then an impairment loss may have occurred.

The recognition of future losses based on possible or expected future trends is not in accordance with the IASB Framework and IAS 37/FRS 12, Provisions, Contingent Liabilities and Contingent Assets. General provisions would therefore not be allowed as the historical experience is zero and it is unlikely to produce an acceptable estimate of the cash flows to be received.

CONCLUSION

Trade receivables/debtors fall into the category of loans and receivables under IAS 39/FRS 26. They will be valued at fair value initially - which will be the invoiced amount. Because they are short-term receivables they will not normally be subject to discounting, nor will they normally have an effective interest rate. They will have to be assessed for impairment at each balance sheet date, and will be impaired if the present value of the cash flows is less than the carrying amount.

The assessment can be on an individual or group basis. The old methods of calculating bad debt provisions are unlikely to produce a correct figure for the present value of the future cash flows and general provisions will not comply with the methodology set out in the IAS/FRS. IAS 39/FRS 26 states that the carrying amount of the asset should be reduced either directly or through the use of an allowance account (para 63). The amount of the loss should go to profit or loss. An allowance for impairment losses is possible, but it must be determined in a more logical and systematic way than has often been the case in the past.

APPLICABILITY TO CAT PAPERS 1, 3 AND 6, AND ACCA QUALIFICATION PAPER F3

The main differences that will affect these exams are those in terms of terminology. The terms 'bad debts' and 'irrecoverable debts' will still be used and will relate to specific debts which are not considered to be collectible and so are written off to the income statement/profit and loss account. Effectively, they are 100% impaired.

General allowances/provisions are in effect no longer allowed. However, allowances are still allowed if they are based on past experience, and on the amount of cash which will be collected. The effect on the CAT papers and ACCA Qualification Paper F3 is limited. Questions and answers will be similar to past examination questions.

EXAMPE 1

Note that the differences in terminology or narrative are in bold.

At 31 December 2004, a company's trade receivables/debtors totalled $864,000, and the allowance for receivables/debtors was$38,000. It was decided that specific debts totalling $13,000 were to be written off as the cash was considered to be irrecoverable, and the allowance for receivables/debtors was to be adjusted to the equivalent of 5% of the trade receivables/debtors based on past experience.

QUESTION

That figure should appear in the balance sheet for trade receivables/debtors and in the income statement/profit and loss account for the total of bad debts and the allowance for trade receivables/debtors?

ANSWER

Balance sheet

Trade receivables/debtors $808,450
($864,000 - $13,000 - $42,550)
Income statement/Profit and loss a/c
Bad debts $13,000
Allowance for trade receivables/

debtors ($42,550 - $38,000) $4,550
[($864,000 - $13,000) x 5% = $42,550]

The calculations are exactly the same as for the existing questions. There is little need to worry as the change is really in the terminology and not in the method of calculation for CAT and ACCA Qualification Paper F3 students.

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