Provisioning for doubtful receivables

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. X, a company incorporated in India is a joint venture between an Indian entity and a foreign company. The foreign company has various joint ventures other than the instant case. The foreign company has the following accounting methodology relating to the provisioning for doubtful receivables of all its Asia Pacific business units:

Accounting Policy

"Purpose

The purpose of this policy is to document the proper accounting methodology related to Allowance for Doubtful Accounts for all Asia Pacific's business units.

Procedure

The provision for estimated losses on accounts receivable may be estimated by an acceptable formula (i.e., as a percentage of sales for the period or a percentage of accounts receivable at the end of the period). An acceptable formula is practical and acceptable, but the appropriateness of the formula must be checked periodically by a judgmental evaluation of the collectability of the receivables themselves. The estimated loss should be compared with the current balance in the allowance for doubtful accounts, with the difference being debited or credited to the bad debt provision.

The analysis of the allowance for doubtful accounts must be performed at least quarterly and as of December year-end. However, accounts receivable balances are reviewed monthly for unusual or significant activity to ensure that material adjustments are captured on a timely basis. The analysis should include, at a minimum, review of individually significant accounts and review of an aging analysis that lists each individual account item according to the period of time it has been outstanding. The analysis shall be:

Specific Provision

The specific provision review shall take into account things such as:

- Bankruptcies
- Customers out of business
- High risk accounts

When a customer declares bankruptcy, a provision is established and is typically 100% on the pre-petition amount outstanding. The amount of provision required for 'customers out of business' or 'high risk accounts' is a matter of judgment and credit/collections collaborates with the business unit on the appropriate provision to establish. If a non-receivable is fully provisioned, the company should no longer record interest income.

General Provision

- Applied predetermined percentages against each of the aging buckets,
- Applied against balances after deducting specific provision,
- Percentages determined based on historical analysis,
- Percentages differ by business unit due to type of customers,
- Percentages should be consistently applied each quarter, and
- Percentages should be reviewed annually

2. The querist has stated that as per section A2 of Accounting Policy Memo, it is the responsibility of the business unit vice-president to manage the accounting activities of the region. These responsibilities include but are not limited to:
   - ensure that financial statements and operating reports are prepared accurately and promptly in conformity with accounting policies.
   - ensure that financial and operating controls are cost effective and are adequate to safeguard assets and the integrity of the financial reporting system.
3. As per review of outstanding amounts due to the Asia Pacific entities, 60 to 90 days appear to be the standard timeframe to collect payment. As such, to more accurately reflect the financial position of Asia Pacific entities, the Asia Pacific region will use the percentages below when reviewing the general provision for doubtful accounts:

Days Past Due	% Provisioned
Current	0%
1-30	0%
31-60	0%

Days Past Due	% Provisioned
61-90	10%
91-180	15%
181-360	50%
360+	100%

Provision calculated quarterly

- Calculated based on accounts receivable balances each quarter-end and for December, as of Annual Report (AR) close.
- Meetings scheduled to review analysis details with Chief Financial Officer (CFO) and Financial Planning and Analysis (FP&A) during quarter-end close week.
- Record adjustments before quarter-end close (or on a monthly basis when significant or material event triggers a need for an adjustment to the provision).

Recording of bad debt provision

- Budget or forecast is used as a standard entry each month.
- Additional provision may be recorded monthly or quarterly based on the provision analysis results.

4. *Write-Offs*
When it is determined that a specific account is uncollectible and should be written off, accounts receivable and the allowance are reduced. If it is determined that only part of a particular debt is collectible, the uncollectible amount should be written off. Accounts receivable write-offs are not to be charged directly to income statement.

Write-off approvals

Authorisation Limit	Job Title
Up to USD 100,000	Business-unit Vice President of finance
Up to USD 250,000	Business-unit President
Up to USD 1,000,000	Chief Operating Officer (COO)
Over USD 1,000,000	Investment Committee

5. *Recoveries*
Collections on accounts previously written off are added to the allowance for doubtful accounts. Bad debt recoveries are not credited to income statement accounts unless specifically approved by the vice president and chief accounting officer.
6. *Financial Reporting Package Disclosure*
The following Financial Reporting Package (FRP) schedules are required for the allowance for doubtful accounts:
   - Accounts Receivable Aging
   - Allowance for Doubtful Accounts
7. *Implementation*
This policy is applicable for any financial year in which audited financials have not been issued before the effective date noted above.

B. Query

8. On the basis of the above, the opinion of the Expert Advisory Committee has been sought by the querist on the following issues:
   (i) can a company adopt an accounting policy to allow for doubtful receivable based on ageing?
   (ii) Whether such an accounting policy would be in compliance of Accounting Standard (AS) 1, 'Disclosure of Accounting Policies'.
   (iii) Whether such an allowance impact 'true and fair' nature of the accounts.

C. Points considered by the Committee

9. The Committee notes that the basic issue raised in the query relates to whether provision on doubtful receivables can be made on the basis of ageing of accounts receivables. Accordingly, the Committee has considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, procedure followed for determining the ageing of accounts receivables, accounting for collections against the bad debts written off, viz., bad debt recoveries, policy relating to writing-off of bad debts and the related approval required, etc.
10. With regard to provisioning for bad and doubtful debts, the Committee notes that paragraph 7 of Accounting standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') inter alia, states that "The term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Standard". The Committee further notes that doubtful debt is a contingency and the same is covered under the principles of Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date' notified under the 'Rules'. In this regard, the Committee notes the following paragraphs of AS 4:

> ***"3.1 A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence,***

of one or more uncertain future events."

"4.1 The term "contingencies" used in this Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur."

"5.1 The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements."

"10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and

(b) a reasonable estimate of the amount of the resulting loss can be made.

11. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote."

From the above, the Committee is of the view that doubtful debts is a contingency and accordingly, a provision in respect thereof should be made in the extant case if based on the facts and circumstances, impairment of receivables account is probable and a reasonable estimate of the amount of resulting loss can be made. With regard to the amount of provision to be provided for in respect of doubtful receivables, the Committee notes the following paragraphs of AS 4, notified under the 'Rules':

"4.4 The estimates of the outcome and of the financial effect of contingencies are determined by the judgement of the management of the enterprise. This judgement is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts."

"5.2 The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on information referred to in paragraph 4.4."

"7.1 The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in financial statements.

7.2 In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the amount of the contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progress of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

7.3 If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. An example of such contingencies may be the estimated uncollectable portion of accounts receivable. Another example of such contingencies may be the warranties for products sold. These costs are usually incurred frequently and experience provides a means by which the amount of the liability or loss can be estimated with reasonable precision although the particular transactions that may result in a liability or a loss are not identified. Provision for these costs results in their recognition in the same accounting period in which the related transactions took place."

"8.1 Events which occur between the

balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

8.2 Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date."

From the wholesome reading of the above paragraphs, the Committee notes that the amount to be provided for in respect of doubtful receivables should be determined by the judgement of the management of the enterprise. This judgement is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts. If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. On the basis of the above, the Committee is of the view that the amount in respect of a provision for doubtful receivables should be determined considering the various factors, as discussed above and should not be determined solely on the basis of an acceptable formula, which is based on the percentage of sales or percentage of account receivable considering the ageing of receivables, although such acceptable formula is practically convenient. Further, events occurring after the reporting/balance sheet date that provide additional information materially affecting the determination of the amounts of doubtful provisions, such as insolvency of a receivable, etc. should also be considered and accordingly, adjustments should be made in the amount of provisions for doubtful receivables. In this regard, the Committee notes that the company in the extant case, while determining the percentage of provision takes into consideration historical analysis considering the type of customers and a judgemental evaluation of the collectability of the receivables is also made periodically. Thus, it appears that in the extant case, the company takes into consideration not only ageing but also other relevant factors, as discussed above. Accordingly, the Committee is of the view that if the policy of the company to provide for doubtful receivables takes into consideration various factors, as discussed above, the same would be in compliance of various Accounting standards and would also depict true and fair view of the accounts.

D. Opinion

11. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 8 above:

(i), (ii) and (iii) The company should adopt an accounting policy in respect of provision for doubtful receivables based on various factors as discussed in paragraph 10 above and should not be based solely on ageing of the receivables. If the policy of the company to provide for doubtful receivables takes into consideration various factors, as discussed above, the same would be in compliance of various Accounting Standards and would also depict true and fair view of the accounts.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on April 23, 2015. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty three volumes. A CD of Compendium of Opinions containing thirty three volume has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.