A critical assessment of bad debt assessment based on aging profile

By Filbrert Tsai December 7, 2015

Aging debtor analysis as basis for impairment loss assessment is probably the methodology most familiar in the accounting industry. However, careful analysis of this approach indicates a significant risks that debts are not appropriately assessed for impairment loss.

IAS 39 on financial instrument measurement and recognition requires financial assets to be assessed for impairment at the end of the reporting period. Further, the requirement of the accounting standard is quite stringent yet tangent since it requires debtor balances significant in size to be tested individually while the other debtor accounts will need to be assessed collectively for impairment, but then, the measure of significance is purely a matter of judgment. Most companies apply religiously an approach classifying key customers for specific credit risk assessment and collectively assess other debtor accounts using the age bucket system.

The age bucket system can be traced academically to accounting text books used at the collegiate level which simplifies the approach required by the accounting standard for collective assessment of impairment. In general, most companies will have a systemic way of estimating the amount of impairment loss attributable to each age bracket. As can be seen in practice,

the amount of impairment assigned to each age bracket is usually determined based on estimated amount by management (simply put—instinct) or, in a more sophisticated ERP system, management is able to track the amount of collection at each age bracket and therefore assign a quantitative measure of non-recoverability based on actual historical figures.

Applying valuation adjustments against debtor balance using aging analysis is usually treated as a theoretically sound approach in the accounting industry and acceptable in most audits (other than the usual application of professional judgement). A careful analysis of this approach will highlight significant flaws in this approach which technically renders this approach unacceptable. For ease of understanding, a simplistic illustration (only two debtors involved) is provided below:

	Current	0-6m	6-12m	>12m	Total
Risky Co.	-	20.00	20.00	50.00	90.00
Paying Co.	30.00	20.00	10.00	-	60.00
Total debtor	30.00	40.00	30.00	50.00	150.00
Provision rate	0%	10%	20%	50%	
Bad debts	-	4.00	6.00	25.00	35.00

Risky Co.'s total debt amounts to Currency Unit (CU) 90 while Paying Co.'s total debt amounts to CU60. Using the standard provisioning table applied by most companies, total estimated provision as of the period will be CU35 calculated as the sum product of the debtor age and provision rates. The CU35 provision for bad debts provided against total debtor account is distributed as CU31 and CU4 to Risky Co. and Paying Co., respectively.

Detailed analysis of the customer profile highlights a high likelihood that Risky Co. will actually not be able to pay-off its

debt or is an erring customer. A question will arise whether a 34% (31/90) overall provision rate is a reasonable amount of provision for Risky Co., obviously, based on an audit perspective, the answer will be no. Further, the 7% (4/60) overall provision rate for Paying Co. might not necessarily be a sound amount as well since current debts are liquid yet company debtor books indicate outstanding aged debtor balance—which potentially signifies a contested debtor balance or balance on an extended credit term not appropriately reflected in the aging profile.

The approach above clearly indicates the risks that bad debts are watered down by the existence of newer debts which obviously carry the same credit risk relating to the debtor. Further, the adoption of this approach clearly violates the principle that impairment analysis should be conducted at an apple-to-apple basket risk approach since all debtors are simply lumped together and assessed based on their age-bracket.

While generally, auditors obtain comfort when the applied provision rate is higher than expectation, the above illustration clearly indicates otherwise which we need to go back and revisit our approach. Still, this approach can be hardly challenged in the accounting industry as this is an established practice and even accounting books provides such crude basis of provisioning without a waterline disclosure or health warning as to its application.

The above discussion might prove theoretical but at least we should see some push in the industry to perform a better assessment of impairment by categorizing debtor balances according to their risk profile. In essence, I believe there are three acceptable hierarchies in performing an annual bad debts review, for debtor balances assessed collectively, depending on what extent of available information is at hand:

Hierarchy 1—Debtors are classified according to their risk categories preferably from an externally-sourced risk profiling system. Debtors under each risk categories are then assessed for impairment at each age bracket based on their risk categories.

Hierarchy 2—Debtors which are specifically identified as high risk by the operations team or credit collection department are assessed separately from the whole basket. Debtors under the remaining basket are assessed collectively at each age bracket with an additional padded provision rates to compensate the risk of non-recoverability.

Hierarchy 3—Debtor balances indicating significant amount of aged debt will be assessed separately. Debtors under the remaining basket are assessed collectively at each age bracket with an additional padded provision rates to compensate the high risk of non-recoverability.

While the above discussion are purely thoughts coming out of long time discussion with finance directors of my audit clients, a detailed analysis will need to be undertaken to measure the impact of the offshoot in the provision rates versus actual write-offs and an understanding of the tangent resulting from the varied accounting approaches used to measure bad debts.

Some key questions at the end of this discussion are:

· Are aged debtors really intrinsically more risky than less aged debtor balances?

· Does presenting the aging profile help in assessing the credit risk involved in a set of debtor balance?

· Why are aging debtors continually incurring new debts?

· How statistically correct are estimated provision rates based on aging brackets?

· Is there any better way to attribute risk to the specific debtor in a large data set?