Accounting for Bad Debts Related to Trade Receivables

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Current Accounting During 2019

The concept in generally accepted accounting principles (often referred to as "GAAP") is that impairment of receivables shall be recognized when, based on available information, it is probable that a loss has been incurred based on events and conditions existing at the date of the financial statements. In other words, present GAAP requires an "incurred loss" methodology for recognizing bad debts that postpones the recognition of a loss until it is probable that a loss has been incurred but not yet reported.

The incurred loss methodology requires that businesses record an estimate of uncollectible amounts, typically called an allowance for doubtful accounts. The allowance should be supported by data and analyses and applied consistently from period to period. The allowance is recorded as a charge to expense on the income statement and a credit, representing a reduction of receivables, on the balance sheet. When companies write-off a receivable, the loss, once known, is subtracted from the related trade receivable account balance with a corresponding subtraction from the allowance.

Recoveries of trade receivables that were previously written-off are recorded when received. Practices differ between entities as some industries typically credit recoveries directly to earnings, while financial institutions typically credit the allowance for loan losses for recoveries. The combination of this practice and the practice of frequently reviewing the adequacy of the allowance for loan losses results in the same credit to earnings in an indirect manner.

The Need for Change

In 2008, following the global financial crisis, financial statements users expressed concern that current GAAP did not reflect bad debts that are expected by management at the financial statement date, since some of the "expected losses" do not yet meet the "probable" threshold. In 2016, Financial Accounting Standards Board ("FASB") issued an Accounting Standards Update ("ASU") that amends the accounting for credit losses on receivables. The FASB has also issued several subsequent modifications of its original ASU.

What is the Change About?

The ASU eliminates the probable threshold for initial recognition in current GAAP and, instead, calls for an entity to record a current estimate of expected bad debts. To accomplish this objective the ASU broadens the information that an entity must consider in developing its expected allowance for doubtful accounts measured either collectively or individually.

Businesses should use forward-looking information to develop more timely information in the estimate of expected bad debts, which will be more relevant to users of the financial statements. The FASB does not specify a method for measuring the expected bad debts, net of expected recoveries, and allows an entity to use data and apply methods that reasonably reflect its expectations of the bad debt estimate.

A cash recovery of an amount previously written off shall be recorded with a debit to cash and a credit to the allowance for doubtful accounts. At the next close of an accounting period management shall adjust the allowance for bad debts and record a corresponding charge or credit to bad debt expense. Alternatively, management can record a cash recovery as a direct reduction of bad debt expense.

An entity will apply the ASU and its amendments through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (that is, a modified-retrospective approach).

When is the Change Effective?

The new accounting should be implemented not later than the dates below:

- Public business entities that meet the definition of an SEC filer, excluding entities eligible to be a "smaller reporting company" as defined by the SEC, for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years; and
- All other entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.

How Can Your Accountant Help You?

Your accountant's advice is important, including but not limited to these areas:

- Assisting in the accounting transition and answering any questions that arise concerning the effective date.
- Developing and recording information to arrive at the allowance.
- Addressing any relevant tax questions.
- Understanding the impact, if any, to loan covenant and other ratios that are key to agreements.

About the Author

Dave Grumer is a partner with more than 30 years of experience providing business consulting, tax, and audit services. A leading member of the firm's Financial Services Industry Practice, he advises clients primarily in the financial services industry, including registered investment advisors, registered brokers and dealers, and various investment companies. Dave's work with clients is grounded in his experience in a wide variety of business activities that requires a deep understanding of each clients' operations and cash flows in order to apply his knowledge of the latest developments in accounting, taxation, and compliance.