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White Paper

IFRS Compliance in the Reporting of Receivables

Enablers and Limitations in SAP

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This white paper discusses the challenges in IFRS compliance while reporting Receivables. It explores the relevant business processes in industry; features in SAP that help comply with standards and also the limitations therein

Introduction

Accounts Receivable is one of the most important and critical Balance sheet items. Delayed collections could significantly impact cash flow, delaying manufacturing, purchasing and stocking decisions that are critical for day-to-day business operations. An accurate measurement, reporting and disclosure of Receivables is of paramount importance to any business. The reporting of Receivables is therefore a topic that merits a serious discussion in the context of IFRS compliance.

In almost all enterprise business contexts, the SAP application crystallizes and brings forth to its customers the best practices in industry; it would therefore be interesting from an business application perspective to study the functionality offered by the leading ERP vendor, for the measurement and reporting of receivables in the financial statement. The purpose of this white paper is to discuss the enablers and limitations in the SAP application, vis-à-vis common business practices in industry.

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IFRS compliance and Receivables

In the context of receivables reporting, the two major areas of discussion that are pertinent to accounting compliance are:

- Business practices that enable the accurate measurement of Receivables for IFRS reporting. A key topic here is arriving at a reasonable estimation of Bad debts (receivables which are doubtful).
- IFRS disclosure standards that govern established business processes in the trade of receivables. The main discussion here is on the ownership status of receivables during the generation of revenue using Receivables as a financial asset.

The sections below delve into the above two topics in greater detail.

The question of bad debts

IFRS perspective on Bad debts

IAS 18 gives clear guidelines for the definition and measurement of revenue in the case of sale of goods or rendering of services or the use of the entity's intangible assets like trademark or patent.

Revenue arising from the sale of goods or rendering of services can be recognized only when all of the following criteria have been satisfied:

- When the possibility of future economic benefits to the selling entity exists
- The aforesaid benefits can be measured reliably.
- The associated costs can be measured reliably.

The above definition implicitly sets forth guidelines for treatment of specific components of the financial transaction with the customer that include discounts, surcharges, deferred service costs etc. Further, the above guideline clearly defines a receivable as something which can be collected with certainty. Therefore, the treatment of receivables which are uncertain are of immediate interest from an IFRS perspective. It has to be noted that the write-off of receivables that are believed to be bad debt is not allowed by IFRS.

Common estimation techniques of bad debt in business

Three common techniques prevail in accounting practice while provisioning for doubtful receivables:

- Aging analysis method
- Percentage of credit sales
- Percentage of total accounts receivable

The first technique which provisions based on age of receivables tries to correlate the collectability of a receivable with its age – the older a receivable, the more difficult it becomes to collect it. This technique is relevant in situations where historical data suggest the non-collectability of a receivable beyond a certain age. An aging analysis is done at the end of the period of outstanding receivables, and receivables are categorized into buckets. An amount is provisioned for each bucket

In the second technique, the provisions for bad debt based on a historically determined percentage of credit sales is less cumbersome and can be applied in situations where the business is pretty stable and the receivables are pretty much predictable. However, this ignores the role of aging as a variable and this could be risky.

The third technique allows provisioning for bad debt based on a historically determined percentage of the total outstanding receivables.

Each of the said techniques has its own pros and cons. The choice of a particular technique depends on the tradeoff between ease of applicability and the accuracy in measurement. For example, the percentage of credit sales technique lends itself to easier application in a rapid price and demand change environment. The aging method, on the other hand is more accurate and reliable. This is by far the most transparent of the techniques.

While IFRS is not explicit about which method is preferred, ***IAS 18*** implicitly stresses on the accuracy of the chosen method in a given situation. Many businesses prefer the aging based method, because of the transparency with respect to the uncollectability of old receivables.

Bad debts – Techniques available in SAP and limitations

In a given business situation the most relevant estimation technique, therefore, is the one that predicts a result that is as near to the actual bad debt expense as possible.

SAP supports only the aging technique. It is possible to define multiple percentage based provisioning frameworks, based on the due dates of the receivables.

The limitation of SAP stems from the restricted options it offers to its clients who would like to change the approach of bad debt estimation in a dynamic market situation. The *raison d'être* of a technique that was designed many years earlier may not exist any longer due to external changes like a change in the risk profile of receivables.

Being able to choose an appropriate technique that reflects present customer payment behavior is something many clients of SAP would be interested in.

The SAP-RBD (Reserve for Bad debts) solution is a tool only for the Banking solution and is not relevant for the general enterprise.

The question of ownership of receivables

Revenue generation from receivables – industry practices involved

A broad spectrum of business transactions generates revenue from the trade of Receivables as a financial asset. Firms resort to such arrangements to cater to short term cash needs, to mitigate the risk from variable cash flows. These could involve the use of Invoices as collateral or as the object of sale, with varying degrees of ownership.

The trading of receivables can be carried out at varying levels of ownership of the owner of the Receivable.

Factoring without recourse is a full-fledged sale that transfers the title of the receivable to the factor (new owner), who buys the receivable at a discount. The payment on the receivables is directly sent to the factor. The risk of bad debts is transferred to the factor.

Factoring with recourse is one where despite the transfer of the title to the factor, the risks involved with bad debt on the receivables is still retained by the original title holder in some form.

On the other hand, ***Pledging*** and ***Assignment*** of Receivables are two important means of generating revenue out of Receivables, without a transfer of title to the third party. In both these transactions, the owner of the receivables has full recourse and can demand payment from the borrower of the loan, in case of defaulting.

Unlike a full-fledged sale, the receivables are only used as security against loans from borrowers. The lending entity does not have any direct rights over the payments from the end customer. The payments continue to be directly made to the original owner of the receivable who has pledged or assigned it.

IFRS perspective on ownership of Receivables

While IFRS is not explicit about the handling of revenue generated from receivables, some very relevant guidelines are available from various clauses of IAS like ***IAS 39*** (for recognition and measurement), ***IAS 32*** (for presentation) and ***IFRS 7*** (for disclosure in the financial statement).

IAS 39 guidelines on recognition declare that a financial asset ought not to be stated in the Balance sheet anymore (meaning they have to be derecognized), when one of the following criteria is met:

- The right to the cash flows of the asset has expired.

- The entity has transferred the rights to receive the cash flow from the asset to another entity and has substantially transferred the rights to all risks and rewards
- The reporting entity has lost control of the asset.

Certain key points like recourse and the retention of risk by the borrower clearly guide the question of derecognition – even if an iota of risk is assumed by the borrower, he has to state the receivable in the financial statement, according to the latest interpretation of the derecognition rules of ***IAS 39***.

Factoring without recourse is an outright sale and the receivable has to be derecognized (not mentioned in the Balance sheet), while the same cannot be said about Factoring with recourse (Has to be mentioned in the Balance sheet).The key question here is about the assumption of risk of bad debt.

The disclosure of pledged receivables is necessitated by the requirements in ***IFRS 7***, which requires financial assets pledged as collateral to be disclosed. Here the receivables still continue to be stated in the financial statement, with a footnote disclosure.

It is clear from the above guidelines that the way a receivable is stated depends to a large extent on the level of control exercised over it by the reporting entity.

Recognizing receivables based on ownership – available SAP Functionality and limitations

SAP offers adequate functionality in addressing certain areas of this key topic like pledging, while offering only limited functionality in areas like factoring. From an overall perspective of recognizing receivables based on ownership, the functionality is rather limited.

SAP has an inbuilt functionality to identify and report ***pledged receivables***. The pledging procedure functionality can be enabled at the level of each company code, the entity at which it is possible to draw out a financial statement. The pledging indicator can be set in the customer master data, which then is transferred to all open items posted on that customer. It can also be set at the level of individual open items.

The functionality just serves the purpose of an indicator and can only be used in the open items reporting and for subsequent evaluations. It does not trigger any process with a third party for the borrowings process or make any postings from the borrower against the pledged items.

Factoring without recourse is a full-fledged sale and does not need to be shown in the Balance sheet. It can be booked in the SAP system as a sale, after allowing for a discount in the value of the receivable. However, the system has a serious limitation in recording a ***factoring with recourse*** arrangement, where the risk of bad debt is retained by the borrower. The system has no way of identifying such an item or a group of items with a certain customer.

Conclusion

SAP standard functionality in the context of measurement, recognition and reporting of Receivables is a mixed bag, with enablers as well as obvious limitations.

The concepts in question are quite dynamic, given the changing nature of accounting principles and industry standards on some of the involved business processes (e.g., factoring with recourse).

The gap between industry standards and available standard SAP functionality could be explained by the variety and extent of business processes involved, vis-à-vis the actual need for the functionality. For example, the popularity of factoring and other trade in receivables is restricted to certain geographies and the small and medium industries (SMEs). The factoring trade in the UK and Ireland is fivefold more than that in Germany. However, recent trends indicate an increasing attractiveness of factoring as a mainstream business process. It is gaining currency as an effective way to increase working capital and as an alternative to loans. Accounts receivable factoring is a EUR 650 billion business in Europe.

Sophisticated solutions that provide a further choice of frameworks in the provisioning of bad-debts area can be viable alternatives in times of changing customer payment behavior. Add-on solutions in the receivables trade area that supplement the SAP standard solution would be well received by customers who can then seamlessly integrate the process with the standard SAP accounting software. This is an area that has to be researched further for a viable set of solutions.

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