

BAD DEBTS PRACTICES OF SELECTED SMALL AND MEDIUM ENTERPRISES IN THE PHILIPPINES

Venus C. Ibarra
University of Guam
venus.ibarra@yahoo.com

— *Review of* —
**Integrative
Business &
Economics**
— *Research* —

ABSTRACT

The concept of bad debts expense is relevant to companies that use the accrual basis of accounting and are heavy on credit sales. Uncollectible accounts or bad debts reduce revenue and recognition of bad debts is crucial in presenting the correct revenues of the company. This paper looks at the bad debts practices of 130 selected small and medium enterprises in the Philippines. This study shows whether or not the practices are in accordance with generally accepted accounting principles (GAAP), whether there are significant differences in the methods depending on their business location and type of business. This study also determines how bad debts expense and bad debts written-off affect the overall operating expenses of the businesses.

Findings show that SMEs in all areas surveyed did not follow generally accepted principles of matching in handling and recording bad debts. Out of 130 respondents, 38.5% use the direct write-off method instead of the allowance method. Only 30.7% uses the allowance method broken down as follows: percentage of accounts receivable (16.1%); percentage of sales (6.9%); and aging (7.7%). A high percentage of the respondents (30.8%) do not have any method of handling bad debts. There are no significant differences in the bad debts practices by location or type of businesses. Bad debts represent a very small percentage (4.39%) of the operating expenses of companies. The bad debts expense estimates were almost the same as the bad debts written off.

Keywords: Bad debts practices of SMEs

INTRODUCTION

Small and Medium enterprises (SMEs) are an important part of a nation's economic and social structure as they play a very important role in creating employment opportunities for the growing labour force. The role of business enterprises is essential in pulling up the country's economic development. SMEs exert a strong influence on the economies of all countries, particularly in developing countries. SMEs are the backbone of any economy as they not only create new jobs, but they are also considered as major channels of innovation and technological change (Storey, 1994).

In the Philippines, SMEs play a vital role not only in wealth creation but also in dispersing new industries to the countryside that contributes to a more equitable distribution of income, encouraging entrepreneurial development, stimulating gainful employment, support export growth and a potent force in efforts against poverty. To encourage the development of SMEs, the Government of the Philippines enacted into law the Magna Carta of Small Enterprises (Republic Act 6977) which outlines the general policies for the development of SMEs. Given

their economic and social importance, Philippine SMEs are considered to be vital in the recovery of the national economy.

The Philippine SME sector is composed of micro, small and medium enterprises engaged in industry, trading, agribusiness and services. SMEs are defined as any business activity or enterprise engaged in industry, commerce, agribusiness and/or services, whether single proprietorship, partnership, cooperative or corporation, whose total assets, inclusive of those arising from loans but exclusive of the land on which the particular business entity's office, plant and equipment are situated must have value falling under the following categories: Micro-enterprises have less than Php1.5 million in total assets and 1-9 employees; Small-enterprises have Php1.5 million to Php15 million up to Php100 million in total assets and 10-99 employees; and, Medium-enterprises have more than Php15 million up to Php100 million in total assets and 100-199 employees (Magna Carta of Small Enterprises RA 6977, as amended by RA 8289).

As of 2006 there are 783,065 business enterprises operating in the Philippines; 99.7% or 780,469 are MSMEs (micro, small and medium enterprises) and the remaining 0.3% or 2,596 are large enterprises. Of the total number of MSMEs, 92% or 720,191 are micro enterprises, 7.3% or 57,439 are small enterprises, and only 0.4% or 2,839 are medium enterprises.

Majority of the MSMEs in operation in 2006 can be found in the National Capital Region (NCR), with 194,549 business establishments; Region 4-A (CALABARZON) with 113,581; Region 3 (Central Luzon) with 84,175; Region 6 (Western Visayas) with 46,195; and Region 1 (Ilocos Province) with 44,085. These top five locations accounted for about 61.8% of the total number of MSME establishments in the country. By industry sector, MSMEs in the wholesale and retail trade generated the most number of jobs (with 1,181,525) in 2006 followed by MSMEs in manufacturing, 644,927; hotels and restaurants, 427,153; real estate, renting, and business activities, 242,122; and education, 180,265 (Department of Trade and Industry, 2006).

Bad debts expense is one of the several noncash expenses in the income statement. The concept of bad debts expense is relevant to companies that use the accrual basis of accounting and are heavy on credit sales. Uncollectible account or a bad debt reduces revenue. Improper valuation of this expense may either overstate or understate the revenue of a company. Recognition of bad debts is crucial in presenting the correct revenue of the company.

A bad debt is money owed that cannot be collected. A debt becomes "*bad*" or uncollectible when surrounding facts and circumstances indicate that there is no longer any chance that the amount owed will be paid. A bad debt is written off as a loss to the business.

There is a difference in recognizing bad debts for income statement presentation and for the purpose of taxation. The income statement follows the accrual basis of accounting, and should follow the allowance method in the presentation of bad debts. On the other hand, the direct-write off method is also allowed in the income statement for taxation purposes. The United States Internal Revenue Service (IRS) no longer allows businesses to use the allowance method in accounting for bad debts. The direct write-off method is required in computing their taxable income.

Matching concepts is a generally accepted accounting principle (GAAP). The matching rule dictates that revenues must be assigned to the accounting period in which the goods are sold or the services performed, and expenses must be assigned to the accounting period in which they are used to produce revenue. Under the allowance method, losses from bad debts are matched against the sales they help produce. Under direct write-off, bad debts are usually recorded in a different accounting period from the one in which the sale takes place; the method therefore does not conform to the matching rule (Needles, Powers, & Crosson, 2007).

International Financial Reporting Standards (IFRS) for small and medium sized entities are modified and simplified to meet the needs of private company financial reporting users and easing the financial burden on private companies through a cost-benefit approach. US private companies are not required to use a particular basis of accounting when preparing their financial statements. The factors that drive a private company's choice of which financial accounting and framework to follow in preparing its financial statements depends upon each company's objectives and the needs of their financial statement users.

According to American Institute of Certified Public Accountant (AICPA) overview of IFRS for SMEs, small and medium entities are businesses that publish financial statements for external users but have no public accountability. It is only publicly accountable if it is a publicly traded company, or acts in a fiduciary capacity and holds assets for brokers and outsiders, such as banks or insurance companies.

1. REVIEW OF RELATED LITERATURE AND STUDIES

In general, the literatures on bad debts estimation are mostly technical in nature. They deal extensively with generally accepted principles, actual practices in estimation and write-offs, and the implications of such on the financial statements, particularly in terms of taxation and reporting to managers and investors. A large part of the literature is composed of legal case studies, reports by government agencies, and management textbooks and papers; not many were academic undertakings on how bad debts estimation was used in different companies. Most of the literature discusses the implications and write-off of bad debts, none of them truly delved into the methods commonly used, if any, by these companies and how these could have implications on their finances.

Not much research has previously been done regarding the write-off and estimation of bad debts, particularly for small to medium-sized enterprises (SMEs). Only one was actually a survey on the methods used by companies, and only one study was found proposing a new approach to bad debt modeling.

Nevertheless, despite the apparent lack of material regarding bad debts estimation, the literature found is still worth reviewing because it gives insight as to the different legal contexts in which bad debts estimation is practiced, and how these practices may vary. It also acquaints us with how different companies use particular methods of managing receivables and collection issues, which varies as well depending on the nature of the firm using it.

The discussion of the sources will be grouped according to the principles they focused on. Case studies and government reports tended to deal with actual practices in write-offs and estimation, while technical accounting literature tended to lean towards theory and accepted principles. Thus, the literatures in this research will be divided according to the following: Theories of Bad Debts, Practices in Bad Debt Estimation, and Implications on Financial Reporting.

1.1 Theories of Bad Debts

While there is no specific definition of a bad debt, it can be generalized as follows: a debt that occurs when a firm believes that a debtor is unable or unwilling to pay and the business will never be able to recover the money owed (Ireland, 2005). It is, therefore, a debt that cannot be collected, or one whose collection would be uneconomical to pursue. Generally, in these circumstances the bad debts are written off, which is essentially a cancellation of the debt to

remove its effects on the accuracy of the statements. Only specifically identified amounts are written off as bad debts.

Speaking of 'bad debt estimation', however, is a misnomer; we are actually speaking about 'doubtful debts', or those circumstances wherein a firm believes there is a decreased likelihood (often substantial) of a debtor paying his debt, for various reasons. It is essentially grounded in two generally accepted accounting principles. The first is the matching principle, wherein revenues are recognized when earned and not received, and expenses are recognized when incurred, not paid. This method of recording matches income to the period it was generated without relying on the actual timing of cash flows. The second is the objectivity principle, which says that the value of balance sheet items such as the accounts receivable should reflect their expected realizable value (Prosser, 2003).

Matching concepts is a generally accepted principle. The matching rule dictates that "Revenues must be assigned to the accounting period in which the goods are sold or the services performed, and expenses must be assigned to the accounting period in which they are used to produce revenue". Under the allowance method, losses from bad debts are matched against the sales they help produce. Under direct write-off, bad debts is usually recorded in a different accounting period from the one in which the sale takes place, the method therefore does not conform with the matching rule (Needles, et al., 2007).

This distinction, however, creates a dichotomy in how such debts are handled. Bad debts are generally written off, which simply involves deducting the amount of the bad debt from the debtors balance directly, with the company incurring an expense ("Bad Debts Expense") in the process. This is the "direct write-off" method of recognizing bad debts. Books in accounting classify this practice as not within the generally accepted accounting principles, and therefore is not acceptable. General practice dictates that bad debts are written off soon as they are identified. On the other hand, providing for doubtful debts involves creating an account called "Allowance for Doubtful Accounts," which is a contra account to the Accounts Receivable on the balance sheet. The rules for creating this provision (% of Credit Sales, % of ending Accounts Receivable, Ageing of Accounts Receivable, etc.) vary, but the basic concept is to allow for debts that may be potentially written off in the future to match the revenue at the time the revenue is recognized. This is the more acceptable method and is within the generally accepted accounting principles. In this case, a doubtful debt that becomes bad is written off with a debit to the allowance account, and a credit to the accounts receivable. In both methods the balance of the debtors account is reduced, however, the timely effects of the bad debts expense in the income statement may vary and may be in contrary to the matching principle.

Bad and doubtful debts share many similar characteristics, the only real difference being their level of collectability. According to Prosser, the general rule is that any debt greater than 6 months must be carefully considered as a bad debt, though a debt can become 'bad' at any time within its life cycle depending on the circumstances, while debts can be classified doubtful when a debt is aged 90 days or more. Additionally, bad debts are generally the result of objective evidence, i.e. when there is proof or advice from an independent third party regarding the uncollectable debt, while doubtful debts are based on subjective, though not entirely arbitrary, estimations.

In 1990 Gerard Scallan tried to propose using Markov chains, a complicated statistical tool, as a new approach to bad debt modeling. Without going into the mathematical intricacies, the model defines debts to be in any of a set of "risk states," and a debt can jump from one state to any other—or remain put—in successive periods. Using this process, Scallan argues, could not

only project bad debt but also simulate what-if scenarios of changing various credit policies in relation to bad debt. However, no data has been found regarding the use of such a model in current accounting practices.

1.2 Practices in Bad Debt Estimation

When and how bad debts are recognized under the law varies from country to country, and so do the policies regarding the reporting of such write-offs and estimates. The methods used in estimating doubtful accounts also differ depending on the nature of the company or business. These findings, policies and practices are briefly outlined below.

According to research done in the United Kingdom, SMEs in particular write off an average of £14,000 in bad debt per annum, which means that at a 5% profit margin they would have to make additional sales of £280,000 to make up for the loss. (TAK-Credit Management, 2009). According to Williams, Charles & Scott Ltd (2011), an independent collection service firm based in New York, a business with a net profit of 2% experiencing \$100,000 in write-offs would require an additional \$5,000,000 in sales to offset the loss of profit in write-offs. In any case, these show that bad debts do not simply affect a company's cash flow and bottom line performance, but sales and marketing efforts as well—a crucial issue for start-up or growth companies such as SMEs. Thus, effective management of receivables is crucial for the success of any company with a credit policy.

In “Avoiding Business Failure: A Guide for SMEs,” a paper published by the European Federation of Accountants (FEE, *Fédération des Experts Comptables Européens* in French) in 2004, impending bad debt was identified as one of the possible major causes of business failure among SMEs. According to the report,

“The main problem for SMEs, though, may be in actually identifying potential bad debts and being able to reduce them. In many SMEs, there will not be an in-house credit collection department which is able to undertake regular credit control activity and follow up matters of going-concern. For this reason, bad debts may have a more dramatic impact on SMEs than on larger businesses.”

The findings are relevant in light of the fact that in 2004, 99% of all businesses in the European Economic Area are SMEs, with two-thirds of the entire labor force employed there.

In terms of the methods used by businesses in general, a quick survey was conducted by Credit Research Foundation in 2002 covering a wide variety of industry sectors in the United States. It recognized three generally accepted procedures that may be used in estimating doubtful debts, namely the Percentage of Credit Sales, Percentage of Ending Accounts Receivable, and Aging Accounts Receivable, while the direct write-off was recognized for situations where it is impossible to estimate the amount uncollectible from a period with reasonable accuracy. The survey yielded the following key points:

- Out of 160 respondents (30.5% response rate), 26% use the direct write-off method, while 74% use the allowance method.
- Of those who use the allowance method, 30% use Percentage of Credit Sales, 28% use Aging Accounts Receivable, and 15% use Percentage of Ending Accounts Receivable.
- 89% of firms have not altered their estimation methods over the last five years.

- In writing off debts, 65% wait for factual evidence of an inability to pay while 35% write off as soon as a reasonable estimate of loss can be established.
- 87% of the firms using the direct write-off method write off the receivable as soon as it is clear that the account is uncollectible, as opposed to writing off at the end of the year.

The survey yields two insights. First, that as an estimate, there is an element of subjectivity with regard to the recognition of bad debts, which therefore affects the reported value of profits and the Accounts Receivable account. Second, since an allowance in effect writes-down Accounts Receivable to a probable liquidation value, the nature of management also affects how much allowance is made and reported. Conservative management would prefer to establish a high allowance, which is advantageous if a series of insolvencies are encountered, but understates profits as a result of the large amount.

In terms of bad debt estimation, the practices vary. According to the most recent IFRS, under IAS 39, the system of allowances has been replaced by the recognition of impairment losses. An impairment loss adjusts the carrying value of a receivable to its fair value or recoverable amount and may be recognized only as a result of the occurrence of a loss event. The amount of the loss is the difference between the receivable's carrying amount and the present value of expected future cash flows discounted at the receivable's effective interest rate (recoverable amount). Under the French GAAP, such a loss event includes failure to pay a single installment in 90 days, while historical loss data can be used to estimate the impairment loss. This difference between the allowance previously allowed and the impairment loss estimate is recorded as an adjustment to retained earnings.

In the United States the Internal Revenue Service (IRS) no longer allows businesses to use the allowance method in accounting for bad debts, instead requiring the direct write-off method (Day, 2008). However, businesses are usually left free to judge when an account receivable is determined to be uncollectible. Auditors ideally provide a check and balance for these estimates, often requiring them to provide substantial reasons and proof for write-offs, but as has been seen in the current financial climate, when auditors collude with businesses the credibility of financial reporting may be put into question. An interesting case study on the SEC vs. California Micro Devices Inc. actually deals with this extensively (Capriotti and D'Aquila, 2008).

Another factor for varied practices would also be the nature of the firm in question. Schools, for example, have very specific methods of recording and recognizing losses (University of Queensland, 2009 and California State University, 2008). For big companies which sell products or services on credit to other businesses, a process called debt factoring is often undertaken, wherein the company sells its invoices to a factor who pays an advance and then works on behalf of the business to collect money owed by customers. Once the customer settles an invoice to a factor, the factor releases the remaining balance to the company less any fees. This allows them to manage their receivables better (Business Link, 2009).

Nonetheless, in some places allowances are still allowed. In Nova Scotia, for example, adjustments to allowance accounts and write-offs require approval from the Ministry of Finance. The account titles used vary slightly, and accountants are required to prepare reconciliation statements showing the adjustments to the allowance account and the method used in estimating bad debts.

In the Philippines, according to Sec. 34 (E) of the Tax Code, the following are the requisites for deductibility of bad debts:

1. There must be an existing indebtedness.
2. The debt must be ascertained to be worthless, as when the debtor is insolvent.
3. It must be actually charged off within the taxable year.
4. The debt must be connected to one's profession, trade, or business.

In non-profit organizations in the Philippines, bad debts are usually written off at year-end according to the guide published by the Asia Pacific Philanthropy Consortium in 2006. However, not much data is available for what practices SMEs might generally have, and how these might differ from other industries.

1.3 Implications on Financial Reporting

Generally, most of the literature states that the method of bad debt estimation is mostly affected by its implication on taxation. It could be said that writing off is practiced depending on the tax benefit gained by the company. Writing off debts decreases income, therefore decreasing the amount of tax, and the practice is one of the more well-known tax-saving tactics and strategies in any nation. During seasons of recession and economic downturn, companies have an incentive to write off debts when they are experiencing low profits. However, companies generally only write off when there is a tax benefit to be gained; even in recessions, firms experiencing a loss are not likely to write off debts until it is advantageous for them to do so.

This practice of manipulating figures on the balance sheet and income statement is part of what has been loosely defined as 'creative accounting'. Since the accounting process inevitably involves matters of judgment and resolving conflicts between approaches to the presentation of financial transactions, there is a flexibility, which provides opportunities for manipulation and misrepresentation. These could seriously distort perceptions of the business, and circumstances where estimations are necessary, as in determining how uncollectible bad debts can be, are especially prone to be in such ethical gray areas (Amat et al., 1999).

However, laws tend to limit this by taking a more stringent approach to the estimation and write-off of bad debts, often requiring multiple objective layers of proof before allowing bad debts to be deducted. In New Zealand, penalties have been made more stringent in taking up 'abusive tax positions' in light of alarming tax-evasion trends in the property development and SME contexts. The general principle is that the less estimation an accountant makes, the less propensity there is to manipulate figures to the business' undue favor (Johnson, 2010).

Bad debts generally cannot be avoided, as they are a resultant act of granting credit, and therefore the management question is how to minimize the costs thereof. The level of bad debts may also have a direct correlation with the lending practices of the entity involved and the competitive nature of the business they operate in. For SMEs in particular, bad debts are influenced by the standards adopted by other players in the market. However, the principles of good credit practice are constant regardless of the nature of the market.

There is no research in the Philippines pertaining to bad debts practices of SMEs. The objective, therefore of this paper is to find the answers to the following:

- a. What are SMEs practices in estimating their bad debts?
- b. Are these practices in accordance with the generally accepted accounting principles?
- c. Are there significant differences in the practices in accordance with their location?
- d. Are their significant differences in the practices in accordance with the type of business?

- e. How do bad debts expense and bad debts written off affect the operating expenses of the companies?

2. DATA

When analyzing SMEs and their system of bad debts estimation in the Philippines, the following are two important limitations that should be noted: First, most SMEs surveyed do not have publicly available financial statements; and secondly, SMEs in the Philippines might have very different methods of keeping financial and accounting records.

2.1 The Respondents

Chief Executive Officers (CEOs), finance officers, accountants and owners of companies were interviewed to determine the different practices used by SMEs in handling or treating bad debts. The researcher made use of enumerators to interview the respondents in person or through email or telephone. The interviews were conducted during the last quarter of 2010 and first quarter of 2011.

The initial intention was to survey 100 SMEs and their practices in estimating bad debts. This sample size was derived by using Slovin's formula (Guilford, 1973) at 10% margin of error. One hundred eighty companies were listed and 130 (72%) companies responded. This number lowered the percentage of error to 8.7%. The respondents are diversified in terms of business and location. Most businesses were randomly selected in accordance with their proximity, within 15 kilometer radius, to the center of the cities or provinces.

Areas were limited to the top three locations of SMEs; namely, National Capital Region, Calabarzon, and Central Luzon for a total of 382,305 or 50% of the total SMEs. The National Capital Region (NCR) comprises of 16 cities, namely; Manila, Caloocan, Las Pinas, Malabon, Mandaluyong, Marikina, Muntinlupa, Navotas, Pasay, Pasig, Paranaque, Quezon City, San Juan, Taguig, Valenzuela and Pateros. CALABARZON was formed from the names of six provinces: CAVite, LAGuna, BATangas, Rizal and QueZON. The seven provinces under Central Luzon are: Aurora, Bataan, Bulacan, Nueva Ecija, Pampanga, Tarlac and Zambales.

Respondents were further classified by business; namely, wholesaling and/or retailing, manufacturing, hotels and restaurants, real estate and education.

Table 1. The Respondents

Types of Business	L O C A T I O N				
	NCR	CALA- BARZON	CENTRAL LUZON	TOTAL	%
Wholesale and Retail	29	22	20	71	54.6
Manufacturing	16	8	9	33	25.4
Hotels and Restaurants	5	6	2	13	10
Real Estates	3	3	2	8	6.2
Education	1	1	3	5	3.8
Total	54	40	36	130	100
Percentage	41.5	30.8	27.7	100	

Table 1 shows the type of business and the number of respondents who participated in the survey. Fifty-four or 41.5% of the respondents are from the National Capital Region (NCR), while 40 or 30.8% are from CALABARZON and 36 or 27.7% are from Central Luzon. Most of the respondents are wholesalers and/or retailers (54.6%), followed by 25.4% manufacturers. Twenty percent (20%) of the respondents are from the hotel and restaurant, real estates and education businesses.

3. RESULTS

3.1 SMEs Bad Debts Practices by Location

3.1.1 National Capital Region (NCR)

Table 2. Practices in Estimating Bad Debts - National Capital Region (NCR)

Types of Business	DIRECT	ALLOWANCE METHODS				TOTAL
	WRITE-OFF	% OF SALES	% OF ACCTS. REC.	AGING A/R	NONE	
Wholesale and Retail	14	2	5	2	6	29
Manufacturing	5	2	3	2	4	16
Hotels and Restaurants	2		2		1	5
Real Estates	1		1		1	3
Education	1					1
Total	23	4	11	4	12	54
Percentage	42.6	7.4	20.4	7.4	22.2	100

Twenty-three companies or 42.6% from NCR use the direct-write off method, while 35.2% use the allowance method. Most of the SMEs estimate bad debts by using the percentage of accounts receivable (20.4%) followed by both percentage of sales and aging of accounts receivable at 7.4% each. Twelve or 22.2% of the 54 companies did not use any particular method.

3.1.2 Calabarzon

Table 3. Practices in Estimating Bad Debts – Calabarzon

Types of Business	DIRECT	ALLOWANCE METHODS				TOTAL
	WRITE-OFF	% OF SALES	% OF ACCTS. REC.	AGING A/R	NONE	
Wholesale and Retail	7	2	1	2	10	22
Manufacturing	3				5	8
Hotels and Restaurants	2		1	1	2	6
Real Estates				1	2	3
Education			1			1
Total	12	2	3	4	19	40
Percentage	30	5	7.5	10	47.5	100

There were 40 respondents from the CALABARZON areas. Twelve or 30% of SMEs in these areas directly write-off their bad debts, while a higher percentage (47.5%) does not use any method. Nine of the respondents, corresponding to 22.5%, use the allowance method broken down into 5% percentage of sales, 7.5% percentage of accounts receivable and majority or 10% use aging of accounts receivable. Nineteen or 47.5% of the SMEs located in CALABARZON are not using any method.

3.1.3 Central Luzon

Table 4. Practices in Estimating Bad Debts – Central Luzon

	DIRECT	ALLOWANCE METHODS			TOTAL	
	WRITE-OFF	% OF SALES	% OF ACCTS. REC.	AGING A/R		NONE
Types of Business						
Wholesale and Retail	8	2	4		6	20
Manufacturing	4		1	2	2	9
Hotels and Restaurants		1	1			2
Real Estates	1				1	2
Education	2		1			3
Total	15	3	7	2	9	36
Percentage	41.7	8.3	19.4	5.6	25	100

Fifteen or 41.7% of the total 22 respondents from Central Luzon use the direct write-off method. Twelve or 33.3% uses the allowance methods to estimate their bad debts expense. Most of the SMEs use the percentage of accounts receivable (7) followed by percentage of sales (3). Only 2 SMEs in manufacturing use aging of accounts receivable method while 9 respondents or 25% of the total 36 SMEs from Central Luzon do not use any method.

3.1.4 Practices in Estimating Bad Debts by Location

Table 5. Summary of Practices in Estimating Bad Debts by Location

PRACTICES	L O C A T I O N				
	NCR	CALA-BARZON	CENTRAL LUZON	TOTAL	%
Direct write-off	23	12	15	50	38.5
Allowance method:					
Percentage of sales	4	2	3	9	6.9
Percentage of accounts rec.	11	3	7	21	16.1
Aging of accounts receivable	4	4	2	10	7.7
None	12	19	9	40	30.8
Total	54	40	36	130	100

National Capital Region (NCR) has the most companies (23) that use the direct write-off method, followed by Central Luzon (15) and CALABARZON (12). Majority of the 40
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companies that use the allowance method (30.7%), use the percentage of accounts receivable (16.1%) to estimate their bad debts. SMEs from NCR show the majority number, followed by Central Luzon and lastly CALABARZON. Companies prefer using aging of accounts receivable method (7.7%) rather than the percentage of sale method (6.9%). More SMEs from NCR and the CALABARZON areas than those from Central Luzon use this method. More than 30% (30.8%) of the respondents do not use the direct method or any of the allowance methods. Majority of these companies are located in CALABARZON (19) followed by those in NCR (12) and Central Luzon (9).

3.1.5 Differences in the bad debts practices by Location: Chi-Square test

Hypothesis (HO): There are no significant differences in the bad debts practices by location.

Level of Acceptance or rejection: Accept Ho if and only if the computed chi-square at 5% level of significance is lower than the chi-square of 9.49. Reject HO if and only if the computed chi-square at 5% level of significance is higher than the chi-square value of 9.49. The computed chi-square is 7.71. Therefore, the hypothesis is accepted that there are no significant differences in the methods of handling bad debts by location.

3.2 SMEs Bad Debts Practices by Type of Business

3.2.1 Practices in Estimating Bad Debts by Type of Business

Table 6. Summary of Practices in Estimating Bad Debts by Type of Business

Types of Business	DIRECT	ALLOWANCE METHODS			TOTAL	
	WRITE-OFF	% OF SALES	% OF ACCTS REC.	AGING A/R		NONE
Wholesale and Retail	29	6	10	4	22	71
Manufacturing	12	2	4	4	11	33
Hotels and Restaurants	4	1	4	1	3	13
Real Estates	2	0	1	1	4	8
Education	3	0	2	0	0	5
Total	50	9	21	10	40	130
Percentage	38.5	6.9	16.1	7.7	30.8	100

Out of 130 respondents, 38.5% do not follow the generally accepted principles in recognizing bad debts in their income statements. These companies use the direct write-off method in recording their bad debts. Majority of the companies are from the wholesale and retail sector (29), followed by manufacturing companies (12). The 19 non-compliance companies are those engaged in hotels and restaurants, real estates and education.

Forty companies use the allowance method of estimating bad debts. The most popular method is the percentage of accounts receivable (16.1%), followed by aging of accounts receivable (7.7%) and the least method used is the percentage of sales (6.9%). Ten out of 22 wholesalers that use the allowance method estimate their bad debts using the percentage of accounts receivable. Six companies use the percentage of sales and 4 companies use the aging of accounts receivable method. Manufacturers prefer percentage of accounts receivable and aging

of accounts receivable than the percentage of sales method. Likewise, hotels and restaurants prefer percentage of accounts receivable and aging of accounts receivable than percentage of sales methods. Two out of eight real estate companies use the percentage of accounts receivable and aging methods. Two out of 5 companies engaged in education use the percentage of accounts receivable. An alarming 30.8% or 40 out of the total 130 companies do not use any method at all. Twenty-two of these companies are wholesalers and/or retailers, 11 are manufacturers, 3 hotels and restaurants operators and 4 in real estates.

3.2.2 Differences in the Bad Debts Practices by Type of Business: Chi-square test

Hypothesis (HO): There are no significant differences in the bad debts practices by type of business. Level of Acceptance or rejection: Accept Ho if and only if the computed chi-square at 5% level of significance is lower than the chi-square of 9.49. Reject HO if and only if the computed chi-square at 5% level of significance is higher than the chi-square value of 9.49. The computed chi-square is 1.09; therefore, the hypothesis is accepted that there are no significant differences in the bad debts practices by type of business.

3.3 Effects of Bad Debts Expense and Bad Debts Written-off to the Overall Operating Expenses of the Companies

Only 62 (48%) out of 130 companies were willing to give information on their operating expenses, bad debts expense and bad debts written-off. No financial statements or other financial data were made accessible to the researcher.

Table 7. Summary of Annual Operating Expenses, Bad Debts Expense and Bad Debts Written-off (in Phil. P)

DATA	DIRECT	ALLOWANCE METHODS			ALLOW.	OVERALL
	WRITE-OFF	% OF SALES	% OF ACCTS. REC.	AGING ACCTS.REC.	METHODS TOTAL	
No. of Companies	31	8	14	9	31	62
Operating Expenses (OE)	130,264,634	9,788,805	41,743,921	289,619,772	341152498	812,569,630
Average Operating Expenses	4,202,085	1,223,601	2,981,709	32,179,975	36385285	13,105,962
Bad Debts Expense		1,022,608	923,366	18,771,888	20717862	40,413,116
Average Bad Debts Expense		127,826	65,955	2,085,765	2279546	334,159
Bad Debts Expense vs. OE (%)		10.45%	2.21%	6.48%	6.07%	4.39%
Bad Debts Written-off	1,684,440	552,135	425,153	18,024,431	19001719	39,687,878
Average Bad Debts Written-off	54,337	69,017	30,368	2,002,715	2102100	333,648
Bad Debts Written-off vs. OE (%)	1.29%	5.64%	1.02%	6.22%	5.57%	4.39%
Bad Debts Written-off vs. Bad Debts Expense		53.99%	46.04%	96.02%	91.72%	98.21%

The 31 companies that directly wrote-off bad debts reported their operating expenses at P130,264,634 or an average of P4,303,085 each. The average bad debts written-off per company were P54, 337, which comprises 1.29% of their operating expenses.

Another 31 companies estimated their bad debts expenses using the allowance methods. Eight (8) out of 31 companies that used the percentage of sales showed that their bad debts

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expenses were 10.4% of their operating expenses. Fourteen companies (14) that used the percentage of Accounts Receivable show 2.21% of their operating expenses were bad debts, while nine (9) companies that used aging of Accounts Receivable were showing 6.48% of their operating expenses as bad debts expense.

The actual bad debts written off by companies using the percentage of sales was 5.64% of operating expense, 1.02% for percentage of Accounts Receivable and 6.22% for aging of Accounts Receivable. The overall % of bad debts written off to operating expense under of companies using the allowance methods was 5.57.

Table 7 further shows the actual bad debts written-off as against the estimated bad debts. The overall % of write-off as against bad debts expense for companies using the allowance methods was 91.72%. The overall % of write-off as against bad debts expense was 98.21%.

4. DISCUSSION

Majority of SMEs neither practice the GAAP methods of recording bad debts known as the allowance method nor record bad debts expense. The primary reason in not using the GAAP standard is the lack of familiarity with formal accounting practices. Most recordings are done and kept by the owners themselves. The companies that hire professional accountants and bookkeeping personnel to record business transactions are aware of the differences between the GAAP methods and the BIR or the "direct-write-off" method. However, companies prefer to comply with the BIR methods or standards because they are easier, more convenient to use and these are the methods they know BIR will accept.

Follow-up interviews with the companies that do not record bad debts at all reveal that they do not incur bad debts because they use the cash basis of accounting. Some companies give credit only to trusted clients or customers that assure them of payment on time and therefore, incur no bad debts. Others, like construction companies in the real estate business, use the percentage of completion method to collect revenues. No further work will be completed for the clients if they do not settle their debts on time. Some companies have contracts with the local government and therefore are assured of collection. Some companies feel that their business is small and credit is not encouraged, while some companies do not want to show bad debts in their income statements because of additional supporting documents that the BIR requires.

Bad debts represent only a very small percentage of the operating expenses of companies that used direct off. The same is true with the companies that used the allowance method. In comparing the estimated bad debts to bad debts written off, the companies showed a very high percentage. The estimates were almost the same as the bad debts written off. Not enough data were gathered pertaining to when debts were written-off.

5. CONCLUSION

Thirty-eight point five percent (38.5%) of SMEs do not follow the GAAP methods of recording bad debts known as the allowance method. These companies use the direct write-off method as mandated by the Bureau of Internal Revenue (BIR) rules. Only 30.7% of the SMEs use the allowance method. The percentage of accounts receivable method is the most popular method used by the companies followed by aging of the accounts receivable. The least used method among SMEs is the percentage of sales. An alarming 30.8% of the SMEs do not report nor record bad debts at all.

There are no significant differences in the bad debts practiced or methods of estimating bad debts in accordance with the business location. Likewise, there are no significant differences in the practices in accordance with the type of business.

Bad debts do not affect the operating expenses of the companies. Bad debts expense represents only a small portion of the operating expense. The estimated bad debts expense by using the allowance method is almost the same as the bad debts written off.

It can be concluded that SMEs in the Philippines generally follow the same patterns and practices in determining, estimating, and writing off bad debts. These estimation practices are still left mostly to the judgment of businesses, with government agencies acting as a check-and-balance to make sure that unethical or unfair reporting of bad debts is kept to a minimum. Accounting principles are also moving away from estimating allowances, instead preferring direct write-offs when losses can accurately be determined. Taxation, particularly tax benefits, was also found to be the biggest consideration in determining when companies are liable to recognize or write off bad debts.

Finally, an insight into how SMEs handle their bad debts and their reasons for adopting such give an insight as to how receivables management can be improved for these SMEs. Proper accounting training should be conducted for owners of SMEs in the Philippines. Accounting rules and standards should be coordinated with legislative rules so that there will be no differences in recording bad debts expense for purpose of complying with the GAAP or for tax purposes. Two sets of thoughts and purposes in handling bad debts expense can cause confusions.

APPENDIX

Appendix 1. Difference in Practices by Location (Chi-Square Test Computation)

1. NCR					
Practices	O	E	O-E	O-E ²	(O-E ²)/E
Direct write-off	23	20.8	2.2	4.84	0.23269
Allowance methods	19	16.6	2.4	5.76	0.34699
None	12	16.6	-4.6	21.16	1.2747
Total	54	54			

2. CALABARZON

Practices					
Direct write-off	12	15.4	-3.4	11.56	0.75065
Allowance methods	9	12.3	-3.3	10.89	0.88537
None	19	12.3	6.7	44.89	3.64959
Total	40	40			

3. CENTRAL LUZON

Practices					
Direct write-off	15	13.8	1.2	1.44	0.10435
Allowance methods	12	11.1	0.9	0.81	0.07297
None	9	11.1	-2.1	4.41	0.3973

Total	36	36			
OVERALL total	130	130			7.714606

Chi-square test, at 5% level of significance, DF 4 =

9.49

Appendix 2. Differences in Practices by Business (Chi-Square test computation).

	O	E	O-E	(O-E) ²	(O-E ²)/E
1. Direct write-off					
Wholesale and/or Retail	29	27.3	1.7	2.89	0.105861
Manufacturing	12	12.7	-0.7	0.49	0.038583
Hotels, Restaurants, Real estates, and Education	9	10	-1	1	0.1
Total	50	50			
2. Allowance methods					
Wholesale and/or Retail	20	21.8	-1.8	3.24	0.148624
Manufacturing	10	10.2	-0.2	0.04	0.003922
Hotels, Restaurants, Real estates, and Education	10	8	2	4	0.5
Total	40	40			0
3. None					
Wholesale and/or Retail	22	21.8	0.2	0.04	0.001835
Manufacturing	11	10.2	0.8	0.64	0.062745
Hotels, Restaurants, Real estates, and Education	7	8	-1	1	0.125
Total	40	40			
Overall	130	130			1.086569

Chi-square test, at 5% level of significance, DF 4 =

9.49

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