METHODOLOGY FOR THE IMPAIRMENT OF RECEIVABLES POLICY

To be used from

01 July 2015

CONTENTS:

PURPOSE

The purpose of this document is:

- To set out a methodology for the impairment of receivables in line with the applicable accounting standards;
- To ensure that sufficient allowance is made for the impairment of receivables in the financial statements;
- Ensure that receivables disclosed in the financial statements are stated at amounts that are deemed collectable; and
- To promote transparency as required by sections 215 and 216 of the Constitution when dealing with receivables and debt.

SCOPE

The methodology is applicable to all receivables subsequently measured at amortised cost.

This includes the following line items as disclosed on the statement of financial position:

- Consumer receivables;
- Receivables from exchange transactions; and
- Receivables from non-exchange transactions.

DEFINITIONS AND ABBREVIATIONS

"CFO" means Chief Financial Officer

"Financial year" means the period 1 July of one year to 30 June of the following year (both days included)

"GRAP" means Generally Recognised Accounting Practices

"MFMA" means Municipal Finance Management Act 56 of 2003

"Municipality" means Mohokare Local Municipality

"Reporting date" means 30 June of each year

APPLICABLE ACCOUNTING STANDARDS

GRAP 104 Financial Instruments sets out the requirements and guidelines for the impairment of financial assets subsequently carried at amortised cost.

GRAP 104.46 "*All financial assets measured at amortised cost, or cost, are subject to an impairment review…*"

GRAP 104.57 "*An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraphs .61 to .63 (for financial assets carried at amortised cost) and paragraph .64 (for financial assets carried at cost) to determine the amount of any impairment loss. *"

GRAP 104.58 *"A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a _loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated."*

GRAP 104.61 "*If there is objective evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through the use of an allowance account. The amount of the loss shall be recognised in surplus or deficit."*

GRAP 104.62 *"An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph .58). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment."*

METHODOLOGY

1. **Timing of Assessment**

   The Municipality will assess at the end of each reporting date whether there is objective evidence that a receivable account or group of receivable accounts is impaired.

2. **Evidence of Impairment**

   The following accounts are specifically excluded from impairment testing:

   - Receivable accounts with a combined credit balance at reporting date;
   - Receivable accounts where the combined balance at reporting date is zero;
   - Receivable accounts where the Municipality is the owner; and

- Receivable accounts that have no balance outstanding longer than 30 days at reporting date as these accounts are considered not to be past due.

Any one of the following events is considered to provide objective evidence that a receivable account or group of receivable accounts could be impaired.

- Where the last payment date by the customer was before 1 May of each year;
- Accounts handed over to debt collectors and/or power of attorney;
- All accounts indicated as in-active accounts on the system;
- When accounts have been formally presented to the CFO or Mayoral Committee for write off; and
- All accounts with balances outstanding 90 days and longer as these accounts are considered to be past due

3. Calculation and Recognition of Impairment Loss

The impairment loss is calculated as the difference between the carrying value at reporting date less the present value of expected future cash flows.
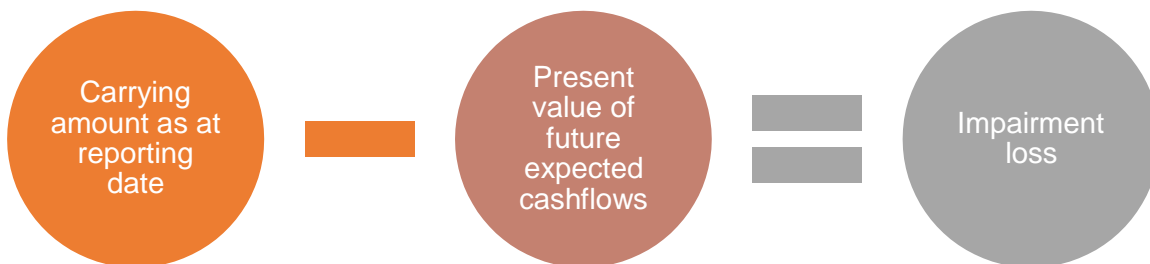
The impairment loss is recognised in the general ledger in the following accounts:

Statement of Financial Position:

Account number	Account description	Line item on statement of financial position
7025/Z010/0000	PROV BAD DEBT	Impairment loss/Reversal of impairment loss - Exchange Rev
7025/Z005/0000	PROV BAD DEBT	Impairment loss/Reversal of impairment loss Non Exchange

Statement of Financial Performance:

Account number	Account description	Line item on statement of financial position
0201/2000/0009	BAD DEBT	Impairment loss/Reversal of impairment loss – Statement of Financial Performance.

4. Individually Significant Receivables

Consumer receivables with outstanding balances, per service, as set out below, is considered material and will be assessed individually for evidence of impairment. Impairment is done per service. The total is given as a reference.

Risk categories

High risk	Medium risk	Low risk
Residential	Business	Government receivables, excluding government schools
Churches	Agriculture: Farmers	
Closed Accounts	Schools.	
Non-active accounts		
Individual accounts assessed as significant above the balances stated below		
RENT	1,000	
RENTAL		Vodacom No Risk
WATER	40,000	
RATES	10,000	
LEVY	4,000	
SEWERAGE	25,000	
REFUSE	20,000	
	100,000	

For sundry receivables management will assess on an annual basis which accounts are considered to be individually material. These accounts will be assessed individually for evidence of impairment.

5. **Risk Categories**

All receivables are categorised into one of three risk categories. These categories are:

- High risk category: Domestic
- Medium risk category: Business, Farmers, Other
- Low risk category: Government.

The allocation of receivables into the different risk categories are reviewed annually.

5.1. **Consumer receivables**

The following receivables are specifically identified as being high risk due to their nature:

- Closed accounts.
- Non-active accounts.

The following receivables are specifically identified as being low risk receivables due to their nature and past payment history:

- Government receivables, excluding government schools

The following receivables are specifically identified as being medium risk receivables due to their nature and past payment history:

- Government school receivables
- Business
- Agriculture i.e. farmers

The remainder of the consumer receivables are classified as high risk receivables.

All other receivables are divided into the three risk categories based on management's knowledge of these receivables.

Summary of risk groups for consumer receivables

High risk	Medium risk	Low risk
Residential	Business	Government receivables, excluding government schools
Churches	Agriculture: Farmers	
Closed Accounts	Schools.	
Non-active accounts		

5.2. Sundry receivables

The following receivables are specifically identified as being high risk due to their nature and past payment history:

- Medical
- Marked to be written off; and
- Handed over accounts

The following receivables are specifically identified as being low risk receivables due to their nature and past payment history:

- Relocation costs.

The remainder of the sundry receivables are classified as medium risk receivables.

All other receivables are divided into the three risk categories based on management's knowledge of these receivables.

Summary of risk groups for consumer receivables

High risk	Medium risk	Low risk
Medical	Remainder of sundry receivable accounts	Relocation costs
Closed accounts		
Marked to be written off		
Handed over accounts		

6. DISCOUNT RATE

The discount rate is set as the yield of the R157 South African government bond as at the reporting date. The actual yield on the R157 bond is sourced from the RMB Global Markets website at reporting date.

http://www.rmb.co.za/globalmarkets/rates_historicalRates.asp?product=Bonds&instrument=R157&rateDisplay=R157#topMenu

The risk free rate is adjusted with a premium per risk category. The following is taken into account in determining the premium:
- The economic conditions of the population in the municipal district;
- History of bad debts written off;
- Effectiveness of the debt collection processes;
- The vast rural area that the municipality covers and the rural population have high social problems;
- High unemployment rate in the municipal district.

Based on the above risk factors identified the risk free rate is adjusted with the following premium

Risk category	Premium adjustment
High risk	1.25%
Medium risk	0.75%
Low risk	0.25%

The risk factors and premium adjustment to the risk free rate are reviewed annually by management.

7. EXPECTED REPAYMENT TERM

One expected repayment term is calculated for high, medium and low risk receivables. The expected repayment term is calculated as the receivables' days at reporting date.

Average receivables balance for the reporting period ÷ Total income from consumers for the reporting period ✕ 365 days

The average receivables balance for the reporting period is calculated as follows:

Balance due as per current period consumer age anslysis + Consumer plus consumer paid in advance as per prior year AFS ÷ 2

The balance due per age analysis include both debit and credit

balances.

The **total amount due** from consumers for the reporting period include:

- Property tax; which includes Rates Levy
- Refuse;
- Sewerage;
- Water;
- Interest on arrears and
- Less income foregone

8. EXPECTED FUTURE CASH FLOWS

The expected future cash flows are based on management's past experiences with the different receivable groups.

The expected future cash flows can be summarised as follows:

Group	Expected future cash flow
Year - end - Procedure	
1. Accounts with no payment received in the last six months	No payment expected
2. Indigent receivables	Accounts marked as indigent do not expect any re-payment and is therefore included at 100% in the allowance calculation.
3. Inactive accounts	No payment expected
4. Accounts marked as bad debts	No payment expected
5. Accounts with balances only in current, 30 days and/or 60 days	Fully recoverable
Future Month-end Calculations	
6. High risk consumer receivables	Based on percentage of the high risk receivable's May balance after billing recovered before June billing
7. Medium risk consumer receivables	Based on percentage of the medium risk receivable's May balance after billing recovered before June billing
8. Low risk consumer receivables	Based on percentage of the low risk receivable's May balance after billing recovered before June billing
9. High risk sundry receivables	Based on the percentage of the high risk receivables June balance recovered before July billing
10. Medium risk sundry receivables	Based on the percentage of the medium risk receivables June balance recovered before July billing
11. Low risk sundry receivables	Based on the percentage of the low risk receivables June balance recovered before July billing

All payments received in July after the reporting date are added to the above calculated expected further cash flows before impairment is calculated.

9.   **PRESENT VALUE OF EXPECTED FUTURE CASH FLOWS**
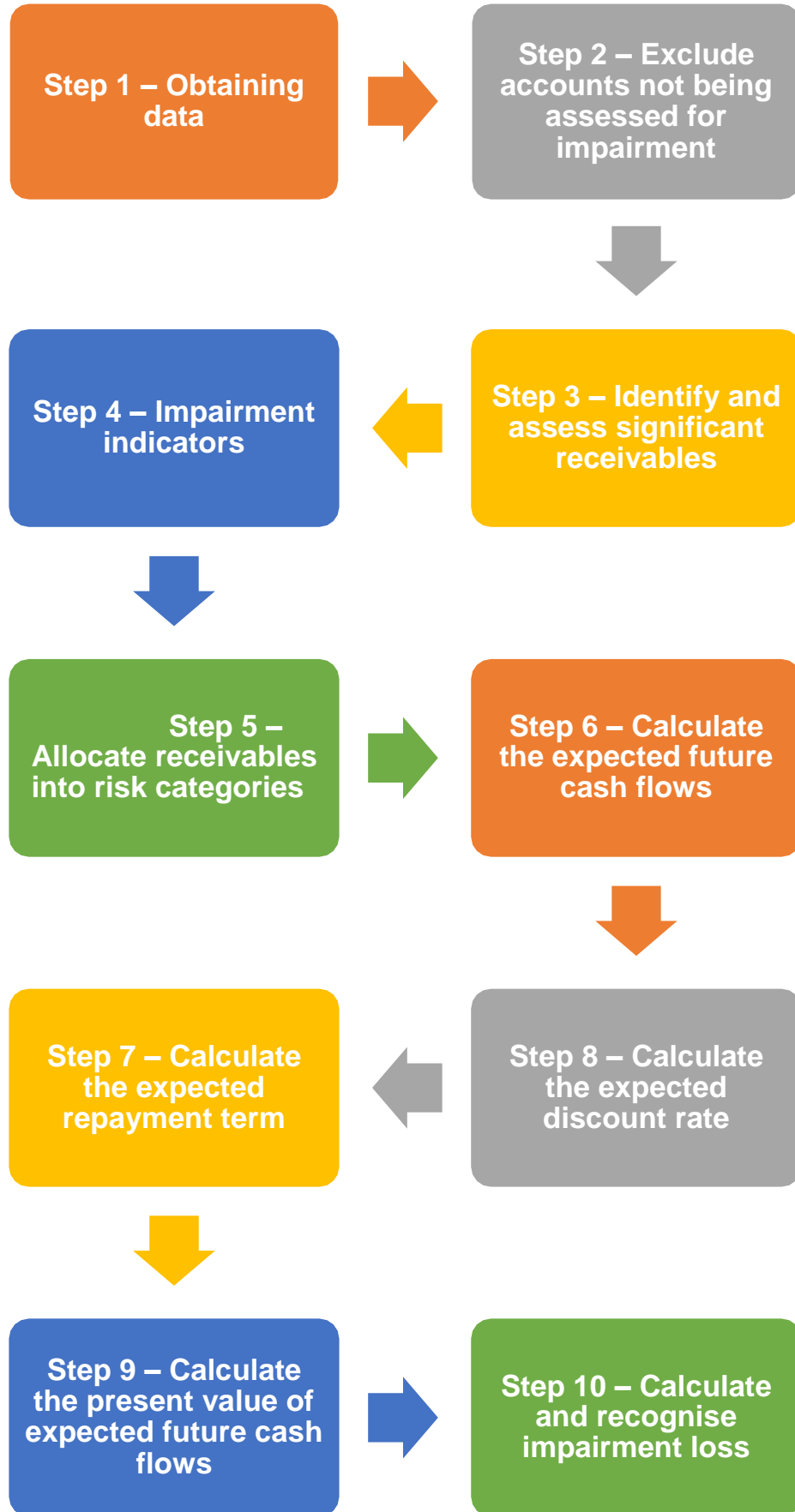
The present value of expected future cash flows is calculated using the

present value formula in MSExcel. The data for input in the formula is the obtained from point 6, 7 and 8 above.

SOURCE

- GRAP 104 Financial Instruments issued October 2009
- GRAP 104 Application Guide issued October 2009
- National Treasury Accounting Guidelines GRAP 104 Financial Instruments

APPENDIX A - WORK PROCEDURES – CONSUMER RECEIVABLES

Step 1 – Obtaining data →	**Step 2 – Exclude accounts not being assessed for impairment**
Step 4 – Impairment indicators ←	**Step 3 – Identify and assess significant receivables**
Step 5 – Allocate receivables into risk categories →	**Step 6 – Calculate the expected future cash flows**
Step 7 – Calculate the expected repayment term ←	**Step 8 – Calculate the expected discount rate**
Step 9 – Calculate the present value of expected future cash flows →	**Step 10 – Calculate and recognise impairment loss**

Tabled – March 2015

Step 1 – <u>Obtaining data</u>

1. Obtain the consumer receivables age analysis as at reporting date

    1.1.   Subtotal all accounts with debit balances.
    1.2.   Subtotal all the accounts with credit balances at reporting date.
    1.3.   Agree above totals with the summary from the financial system.

2. Obtain the following detail for each receivables reflecting on the consumer age analysis at reporting date:

    2.1.   Last payment date (date of payments made on or before reporting date)
    2.2.   Amount paid at last payment date.
    2.3.   Subsequent payment date (date of payments made after reporting date but before next billing date in July)
    2.4.   Amount of subsequent payment.
    2.5.   Hand over indicator
    2.6.   Indicator if status is active or not active.
    2.7.   Indicator of Indigent Status.

3. Obtain prior year financial information. Use Age analysis Excel calculations. Determine debtors and payments in advance.

4. Obtain the total amount for service charges income and interest income on consumer accounts for the reporting period under review, remember to subtract income forgone (Free Basic Service).   USE PC06 – determine BT combined with CE.

    4.1.   Rental – Flats   1020
    4.2.   Rental – Other   1120
    4.3.   Sales of water   4122 plus 4122
    4.4.   Sewerage charges 5020
    4.5.   Refuse removal   6020
    4.6.   Property tax   3050 less 51 (ordinary journals). 53 Is written off on provision account. Allocate different CE for FBS (presently 51)
    4.7.   Levy in lieu of rates   3120
    4.8.   Interest raised on each of above services. BT plus CE21

5. Obtain the following additional data in one file. -   PC06 extracts

    5.1.   Total balance outstanding per consumer just after the May billings were levied
    5.2.   Total balance outstanding per consumer in June, the day just before the levies for June was levied

5.3. Obtain all receipts from the day the May billings were levied to day just before June billings were levied

5.4. Ensure the file obtained include the following as a minimum:

    5.4.1. Account number
    5.4.2. Indicator if status is active or not active
    5.4.3. Indigent Status
    5.4.4. Classification
    5.4.5. Type of use

Step 2 – Exclude accounts not being assessed for impairment

1. Save the consumer age analysis with the file name for example: MLM - Provision for impairment – 30 June 20??

2. From the file saved, identify all of the following accounts and delete them from the age analysis

    2.1. All accounts with zero or credit balances in column Tot Outstanding
    2.2. All accounts in Owner column indicated as MOHOKARE LOCAL MUNICIPALITY identified as municipal buildings.
    2.3. All accounts where there is no balance outstanding over 30 days

Step 3 – Identify and assess significant receivables

1. From the remaining account on the consumer age analysis identify all accounts where the total balance outstanding is above the identified significant outstanding balances as per part 4 of the methodology for impairment of receivables.

2. Cut and save these accounts on a new tab for individual assessment

3. For each account determine their recoverability separately by taking into account the following:

    3.1. Is the account marked as inactive?
    3.2. Has the account been handed over for debt collection?
    3.3. Has the customer made any payments in the last 60 days before year end?
    3.4. Has the customer made any payments after year end?

Step 4 – Impairment indicators

1. If any of the significant receivables were found to be fully recoverable then copy and paste these accounts back onto the receivable age analysis. These receivable no has to be assessed with the remaining group of receivables

2.   Per receivable account determine if any of these indicators exist by indicating a Yes if they exist and a No if they do not exist

    2.1.   Was the last payment date from the receivable before 1 May – this will be Yes if the last payment date is before 1 May
    2.2.   Has the receivable been handed over for debt collection – this would be Yes if consumer is included on the PF04 report as handed over.
    2.3.   Has the receivable account been marked as inactive on the system – this will be Yes if consumer is included on the PF04 report as inactive.
    2.4.   Does the receivable have any balances outstanding 90days and over - this will be Yes if there are any debit amounts in the columns Tot 90days, Tot 120days, Tot 150days and/or Tot 180days

3.   Identify each individual receivable account for which with recoverable amount should be calculated. This will be all the receivables where the answer to any of the above indicators were Yes

Step 5 – <u>Allocate receivables into risk categories</u>

1.   Allocate receivables into the risk categories as per the methodology by inserting a column and indicating the risk category as follows:

    1.1.   High – H
    1.2.   Medium – M
    1.3.   Low – L

2.   Risk categories are determined in the following order:

    2.1.   Non-active accounts – high risk
    2.2.   Indigent accounts – high risk
    2.3.   Business accounts – medium risk
    2.4.   Agriculture accounts – medium risk
    2.5.   Government accounts are categorized as low risk, excluding government schools which are assessed as a medium risk.
    2.6.   Remainder of accounts – high risk – this is all accounts not specifically included in point 2.1 to 2.5 above.
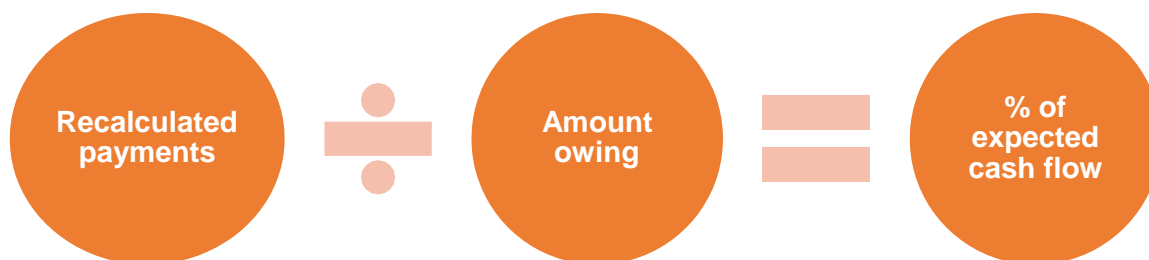
Step 6.1 – <u>Calculate the expected future cash flows for specific risk receivables</u>

1. For all accounts where no indicator of impairment was identified the expected future cash flows are equal to the balance outstanding at reporting date

2. The expected future cash flow for receivable accounts with some specific indicators (list below) are considered to be zero or, if a subsequent payment was received the subsequent payment is considered to be the expected future cash flow. These indicators are:

    2.1. All accounts where no payment has been received in the last 6 months. This will be:
        2.1.1   All account with a last payment date of prior to 1 January 2017
        2.1.2   All accounts in column indicated as INDIGENT
        2.1.3   All accounts in Status column with an indicator of inactive account
        2.1.4   All accounts with a Hand over indicator

3. Identify all the remaining accounts for which no expected future cash flow has been determined in point 1 or 2 above and follow step 6.2

Step 6.2 – <u>Calculate the expected future cash flows for risk categories</u>

1. Take the data obtained in Step 1 point 5

2. From the data received recalculate the payments received to ensure that payments received are not more than the amount owing. This is done in order to eliminate prepayments (where consumer pay more than the balance due)

3. Add a column and allocate the risk categories (H, M or L) per methodology. Risk categories will be allocated in the following order:

    3.1.   Non-active accounts – High Risk
    3.2.   Indigents – High Risk
    3.3.   Business – Medium risk
    3.4.   Agriculture – Medium Risk
    3.5.   Government, excluding schools - they are low risk
    3.6.   Government schools - they are medium risk
    3.7.   Remainder of accounts – High risk

4. Calculate the expected payment term per risk category as:

5. Round the % of expected cash flow to the nearest 10%

Step 7 – <u>Calculate the expected repayment term</u>

1. Calculated the receivables days as per the methodology point 7.

2. Round the receivables' days to the nearest day

3. If the receivables days is lower than 30 days, then use 30 days in the calculation as the expected payment term

4. Use this receivables months as the expected repayment term for all consumer receivables

Step 8 – <u>Calculate the expected discount rate</u>

1. The discount rate per risk category is obtained from the methodology part 6.

Step 9 – <u>Calculate the present value of expected future cash flows</u>

1. For the following receivable accounts, the present value of expected future cash flows is equal to the expected future cash flow calculated in step 6:

    1.1. All accounts where no indicator of impairment was identified is the balance outstanding at reporting date
    1.2. All accounts where there is only amount in column Tot 30 days and/or Tot 60 days

2. For the remaining receivables categorised between the risk categories the present value of expected future cash flows is calculated using the present value formula in excel

Rate: This is the discount rate as per methodology divided by 365 in order to get a daily rate
Total number of payments (Nper): This is the expected term as calculated in step 7 above and is in days
Payment made (pmt): This is zero
Future value (fv): This is the expected future cash flow as calculated in step 6 (4) above
Type: This is nil as payment is expected at the end of the month

3.   Calculate the total present value of expected future cash flows by adding all the individual calculations

4.   Check the total present value of expected future cash flows to ensure that the calculated amount is not higher than the balance outstanding at year end

Step 10 – Calculate and recognise impairment loss

1.   Calculate the impairment loss as the difference between the total balance outstanding as at reporting date and the present value of expected future cash flows as calculated above

2.   Review the list to ensure that none of the amounts calculated in the impairment loss column is in negative

3.   Calculate the movement in the provision by deducting the current year calculated provision from the provision made in the prior year

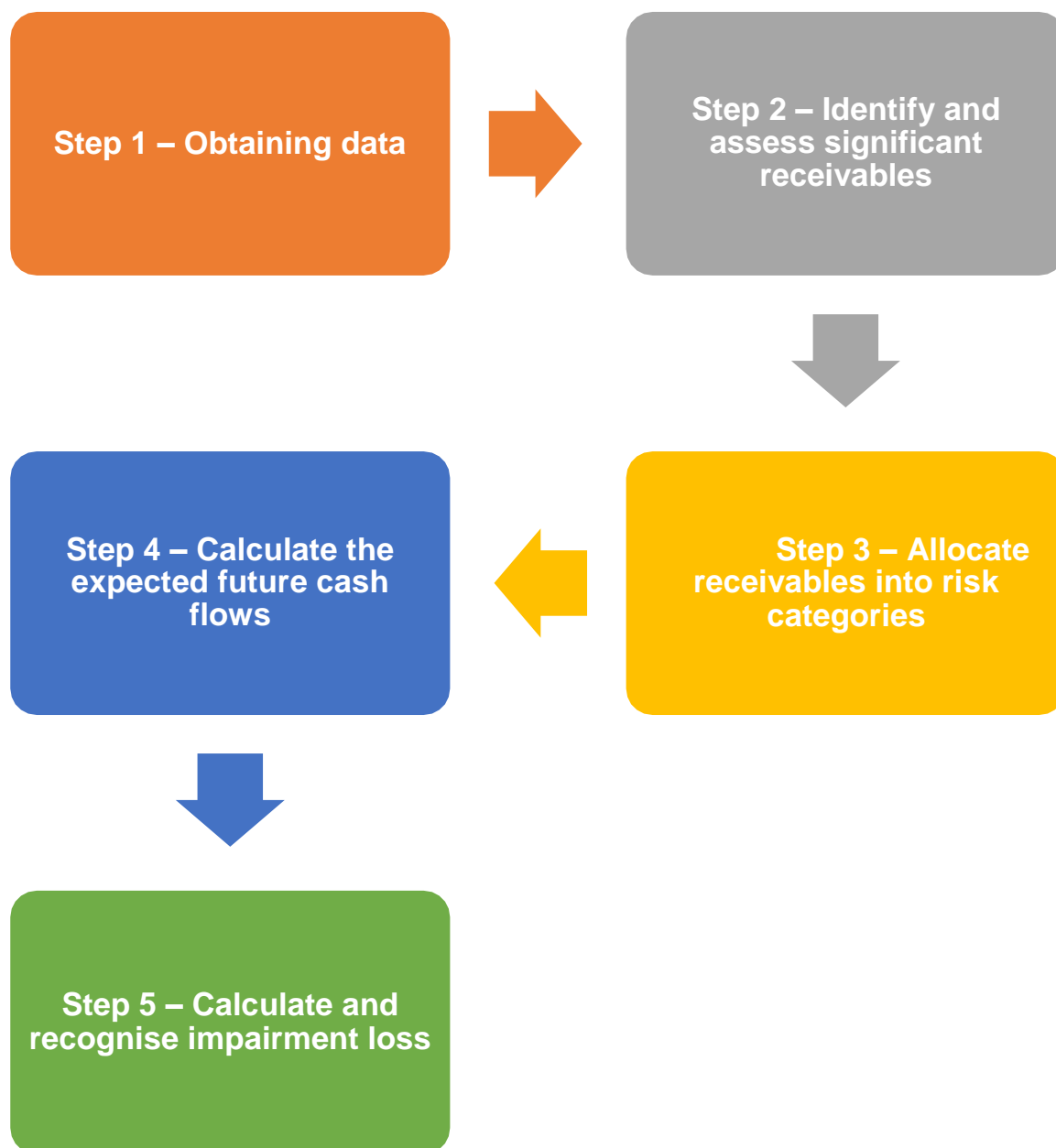| Description	Amount
Current year calculation	(XXX)
Prior year provision	(XX)
Difference	(X)

4.   Prepare a journal to account for the movement as calculated above

4.1.   If current year provision is lower than prior year provision the journal required is

      4.1.1.   DT Statement of financial position

      4.1.2.   CT Statement of financial performance

4.2   If the current year provision is higher than the prior year provision the journal required is:

      4.2.1.   DT Statement of financial performance

      4.2.2.   CT Statement of financial position

APPENDIX B - WORK PROCEDURES – SUNDRY RECEIVABLES

Step 1 – Obtaining data

Step 2 – Identify and assess significant receivables

Step 3 – Allocate receivables into risk categories

Step 4 – Calculate the expected future cash flows

Step 5 – Calculate and recognise impairment loss

Step 1 – Obtaining data

1.	Obtain a list of sundry receivables as at reporting date

2.	Obtain payments received, per sundry receivable between 30 June and 31 July

Step 2 – Identify and assess significant receivables individual

1.	For each account identified as being individual assessed, determine their recoverability separately by taking into account the past payment trend of the receivable

Step 3 – Allocate receivables into risk categories

1.	Allocate accounts not being individually assessed into the risk categories as per the methodology by inserting a column and indicating the risk category as follows:

	1.1.	High – H
	1.2.	Medium – M
	1.3.	Low – L

Step 4 – Calculate the expected future cash flows

1.	Based on past experiences and knowledge of the municipality the expected future cash flows for High and Low risk sundry receivables can be summarised as follows:
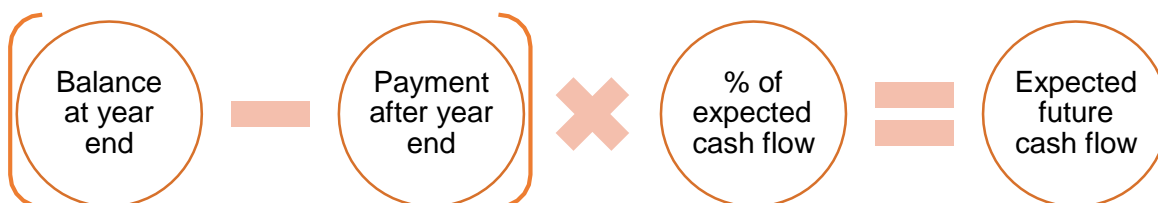
Risk category	Expected future cash flow
High risk	0%
Low risk	100%

2.	Take the data obtained in Step 1 and calculate the % of expected future cash flows for medium risk sundry receivables as follows:

Payment received in July	÷	Amount owing at 30 June	=	% of expected cash flow

3.	Round the % of expected cash flow to the nearest 10%

4. Calculate the expected future cash flow as follows:

$$\left[\text{Balance at year end} - \text{Payment after year end} \right] \times \text{\% of expected cash flow} = \text{Expected future cash flow}$$

Step 5 – Calculate and recognise impairment loss

1. Calculate the impairment loss as:

$$\text{Balance as at year end} - \text{Expected future cash flows} = \text{Impairment loss}$$

2. Review the list to ensure that none of the amounts calculated in the impairment loss column is in negative

3. Calculate the movement in the provision by deducting the current year calculated provision from the provision made in the prior year

Description	Amount
Current year calculation	(XXX)
Prior year provision	(XX)
Difference	(X)

4. Prepare a journal to account for the movement as calculated above

   4.1. If current year provision is lower than prior year provision the journal required is

      4.1.1. DT Statement of financial position
      4.1.2. CT Statement of financial performance

   4.2. If the current year provision is higher than the prior year provision the journal required is: