

## REVIEW ARTICLE

## MANAGERIAL ACCOUNTING PRACTICES OF REPORTING NONCASH EXPENSES OF SELECTED MICRO, SMALL AND MEDIUM ENTERPRISES (MSMES) IN METRO MANILA

Nino Vergel C. Ibarra\*

College of Business Administration, San Pablo Colleges, Philippines  
\*Corresponding Author Email: [onixibarra@yahoo.com](mailto:onixibarra@yahoo.com)

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## ABSTRACT

This study primarily aims to look into the management practices of reporting noncash expenses in the Income Statement of selected MSMEs in Metro Manila. This is descriptive research. Specifically, the study examines MSMEs' common noncash expenses, methods of computation and reporting, and whether these companies show lower or higher noncash expenses according to their needs. Sixteen diversified companies were interviewed. The survey results confirmed that MSMEs' typical noncash expense is depreciation and is computed using the straight-line method. Most MSMEs record their calculated noncash expenses based on the actual value, regardless if it is for income tax or loan application. It shows that MSMEs follow the Bureau of Internal Revenue (BIR) requirements when reporting their noncash expenses in the Income Statement. Additionally, this study discovers that the accounting treatment for reporting noncash expenses provide a suitable basis for owners to review their businesses and determine how to utilize these expenses to their benefits.

## KEYWORDS

Managerial accounting, MSME, Noncash expenses, finance

## 1. INTRODUCTION

According to the Bangko Sentral ng Pilipinas (BSP), the new set of Generally Accepted Accounting Principles (GAAP) are the Philippine Financial Reporting Standards (PFRS) or Philippine Accounting Standards (PAS). These accounting standards are issued by the Accounting Standards Council to be in charge of the preparation of financial statements of businesses in the Philippines. Furthermore, these standards were modeled after the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board. BSP's adoption of the GAAP "is aimed at promoting fairness, transparency and accuracy in financial reporting." ("Regulations - Guidelines and Other Regulations," 2020).

Green practices are matter of big concerns in modern approaches of market and industry (Jain et al., 2017). Based on the 2020 MSME Statistics report of the Department of Trade and Industry (DTI, 2020 list of establishments, PSA), 99.51% (952,969) of business enterprises are MSMEs. Of this, 88.77% comprises Micro enterprises, followed by Small and Medium Enterprises at 10.25% and 0.49%, respectively. The Magna Carta of the Small Enterprises (Republic Act 6977) regulates MSMEs and is still subject to laws on income declaration and other regulations imposed by the Bureau of Internal Revenue (BIR), following accounting standards (Ibarra and Velasco, 2015). According to a study, due to their limited capital, MSMEs' success is significantly influenced by financial resources (Mendoza, 2015).

Laws have required companies to record non-cash transactions despite these not incurring cash flow movement. There are numerous non-cash expenses, the most common ones being: depreciation, amortization, stock-based compensation, unrealized gains, unrealized losses, deferred income

taxes, goodwill impairments, asset write-downs, and provision and contingencies for future losses (CFI, 2020). These are reported to adjust net income and arrive at the true economic viability of the company. Different types of businesses in various industries will have different non-cash particulars reported.

## 1.1 Limitation of the Study

This study explores only the reporting practices of selected MSMEs located in Metro Manila, Philippines on non-cash expense accounts in their income statements. It will not focus on assessing compliance with the standards and laws imposed by the regulating body, such as the Philippine Financial Reporting Standards (PFRS) and the Bureau of Internal Revenue (BIR).

## 1.2 Objectives of the Study

The purpose of this study is to determine what non-cash expenses MSMEs report in their financial statements and see how they differ from each other. This study aims to figure out if reports of specific MSMEs are aligned with their needs. The research study aims to answer the following objectives:

1. To identify the different non-cash expense accounts of the selected MSMEs.
2. To distinguish the similarities and differences in computing non-cash expenses among selected MSMEs.
3. To confirm if MSMEs vary in reporting their non-cash expenses when filing income statements for BIR and when in need of investors or loans.

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## 2. LITERATURE REVIEW

According to the Department of Trade and Industry, Micro, Small, and Medium Enterprises (MSMEs) contributed 35.7% of the total value-added or gross domestic product in 2018. These MSMEs granted 5.7 million jobs or 63.2% of the total employment. By definition, MSMEs are companies with an asset size of less than Php 100 million and an employee size of less than 200. (Congressional Policy and Budget Research Department, House of Representatives, Congress of the Philippines, 2020).

### 2.2 Most Common Non-cash expenses

There are many examples of non-cash expense, but the most common examples include:

#### 2.2.1 Depreciation

The most common non-cash expense is depreciation. Depreciation expense is that portion of a fixed asset considered consumed in the current period, which is then charged to expense. This charge intends to gradually reduce the amount of fixed assets as their value is consumed over time (Bragg, 2022).

Except for land, most plant and equipment items have limited useful life. These fixed assets provide service to the entity over a limited number of future accounting periods. Therefore, a fraction of the asset's cost is properly chargeable as an expense in each accounting period in which it provides service to the entity. The accounting process for this gradual conversion of plant and equipment capitalized cost into expense is called depreciation (Anthony et al., 2010).

There are various acceptable depreciation methods. In the Philippines, different depreciation methods yield varying amounts of depreciation expense. Based on the National Internal Revenue Code of 1997, the different methods of depreciating property, plant, and equipment (PPE) are straight-line method; declining-balance method; sum-of-the-years-digit method; and any other method which may be prescribed by the Secretary of Finance upon recommendation of the Commissioner.

Research done by concluded that although there are various depreciation methods, accountants prefer the straight-line depreciation method because it is easy to compute and can be applied to all long-term assets (Corporate Finance Institute, 2022). However, the straight-line method does not accurately reflect the difference in usage of an asset and may not be the most applicable method to compute the value of some depreciable assets.

#### 2.2.2 Bad Debts

Bad debt expense represents the amount the business estimates will not be paid or collected from the customers. Based on the study conducted by Ibarra in the Philippines, most small and medium enterprises (SMEs) do not follow generally accepted principles of recording bad debts (Ibarra, 2012). The findings show that 38.5% of the surveyed SMEs use the direct write-off method, where expenses are directly written off in the receivables account, while 30.7% use the allowance method. Further, 30.8% of the respondents reportedly do not use any method to record bad debts. Nonetheless, bad debts account for only a small fraction (4.39%) of the companies' operating expenses.

The most common methods to estimate bad debts are direct write-offs and allowance methods. A bad debt expense is directly written off in the corresponding receivables account under the direct write-off method. On the other hand, the allowance method makes use of a separate contra asset account in the balance sheet called allowance for doubtful accounts. Contrary to the direct write-off method, the amount stated in the allowance for doubtful accounts is estimated through the percentage of sales method, accounts receivable aging, and percent of receivables (Magpantay, 2013).

The percent of credit sales method is a method of estimating bad debt under the Generally Accepted Accounting Principles (GAAP) which estimates the uncollectible expense based on the net credit sales and the previous year's uncollected expense (Tamplin, 2022). According to a study by the balance in the allowance account will not affect the estimated bad debt expense since the estimated bad debt expense is related to the nominal account or net credit sales (Magpantay, 2013).

Aging method is another method in estimating bad debts. The basis for the accounts receivable aging method is the time the invoice was provided and the likelihood of collecting the amount. The previous history of the

collection will be used to calculate the estimated bad debt (Corporate Finance Institute, 2022). The accounts receivable aging method is helpful for managers to analyze and make business decisions based on individual accounts. Further, the aging method provides valuable information for the management to adjust their credit policies and discounts (Tamplin, 2021).

The percent of receivables approach, or statement of financial position approach, provides a reasonably accurate estimate of uncollectible receivables using a company's past performance. According to a study conducted by Finger this method is used by companies if the rate of the uncollectible amount is constant throughout the previous years (Finger, 2010).

Under the Bureau of Internal Revenue (BIR) rules, before bad debt expense can be shown as deductible amount in a company's taxable income, it must be proven uncollectible from outstanding customers. Businesses are expected to exhaust all means to collect the said debts before being eligible to be deducted from the accounts receivable and treated as a bad debt expense. According to an article written by the following items are requisites for valid deduction of bad debts from gross income: (a) there must be an existing indebtedness due to the taxpayer which must be valid and legally demandable; (b) the same must be connected with the taxpayer's trade, business or practice of the profession; (c) the same must not be sustained in a transaction entered into between related parties enumerated under Section 36 (B) of the Tax Code of 1997; (d) the same must be charged off the books of accounts of the taxpayer as of the end of the taxable year, and (e) the same must be ascertained to be worthless and uncollectible as of the end of the taxable year (Nonato, 2011).

#### 2.2.3 Another non-cash expense is called amortization.

It pertains to a company's long-term, usually intangible assets. Amortization is the process applied to capital leases, leasehold improvements, and the cost expiration of intangible assets such as patents, copyrights, trademarks, and franchises (Fraser and Ormiston, 2014). According to an article by Amortization is almost always calculated on a straight-line basis. An accelerated amortization method makes little sense since it is difficult to prove that intangible assets are used more rapidly in the early years of their useful lives (Bragg, 2022). In addition, according to a study, the amortization process systematically removes the initial asset's cost from the asset accounts (Anthony et al., 2020). It shows it as a cost of operations. Thus, amortization has no necessary relationship to changes in market value or the asset's actual worth.

#### 2.2.4 Amortization of Leasehold Improvements

Leasehold improvements (LHI) are changes made to a leased space or asset to make it more beneficial to or to fit the tenant's particular needs. Leasehold improvements are assets and part of property, plant, and equipment in the non-current assets section of the balance sheet.

According to an article of not all improvements to a space qualify as leasehold improvements (Reed, 2022). Not all renovations are regarded as leasehold improvements, such as those done to the building's exterior or those that benefit other tenants or the lessor. When accounting for leasehold improvements, the criteria for capitalizing and recording them depend on the business's internal capitalization or materiality policies (i.e., tenant). Here are some common leasehold improvement examples: Customized lighting fixtures, floor finishes, such as carpet, tile, etc., painting walls or other interior space. partitions for separating space, addition of a building to leased land.

The requirements of IFRS 16 will significantly impact on the key accounting ratios of lessees. The greater recognition of leased assets and lease liabilities on the balance sheet will reduce the return on capital employed and increase gearing. Initial profit measures are likely to be reduced as, in the early years of a lease, the combination of depreciation of the right-of-use asset and the finance charge associated with the lease liability will exceed the lease rentals (normally charged on a straight-line basis). (IAS11:IFRS 16 - LEASES, 2021)

#### 2.2.5 Depletion

The cost of acquiring and developing natural resources such as oil and natural gas, other minerals, and standing timber is allocated through depletion (Fraser and Ormiston, 2014). The objective is the same as that for depreciation: to allocate the cost in some systematic manner to the years of the asset's useful life. The unit-of-production method is ordinarily used (Anthony et al., 2010).

According to Investopedia, Depletion is a non-cash expense, similar to

depreciation and amortization, that gradually reduces an asset's cost value through regular charges to income. It refers to the incremental exhaustion of natural resource resources, as opposed to the wearing out of depreciable assets or the aging life of intangibles. To precisely determine the value of the assets on the balance sheet and record expenses in the proper time period on the income statement, depletion is used for accounting and financial reporting purposes. The expenses are systematically distributed over various time periods depending on the resources extracted once the costs related to natural resource extraction have been capitalized. Costs are deferred and kept on the balance sheet until expenses occur (Depletion Definition, 2021).

**2.2.6 Unrealized gains and losses**

The inevitable outcomes of investing are gains and losses. For obvious reasons, all investors seek to gain, yet when things do not go as planned, there is a chance that an investment portfolio will experience losses.

A gain occurs when the current price of an asset increases beyond what an investor pays. In contrast, a loss means the price has decreased since the investment was made. In general, a gain is an increase in the value of an asset while a loss refers to the loss of value. Gains and losses can be both divided into realized and unrealized. Investors realize a gain or a loss when they sell an asset unless the realized price matches exactly what they paid. Unrealized gains and losses reflect changes in the value of an investment before it is sold (What Are Unrealized Gains and Losses? 2022)

Unrealized Gains or Losses, also called "paper profit" or "paper loss.", refer to the increase or decrease in the paper value of the different assets of the company which have not yet been sold. Once such assets are sold, the company will realize the gains or losses (Srivastav, 2022). According to the article it is important to know the unrealized gain on the portfolio since it helps track its performance. These profits are merely "on paper," but they provide a good indication of what actual profits could be short if the positions are sold. They also help in tax planning since taxes are paid only on realized gains; thus, by knowing the unrealized gain, the business can predict the amount of tax to be paid if they sell the securities.

**2.2.7 Asset write-downs**

A write-down is an accounting term for the reduction in the book value of an asset when its fair market value (FMV) has fallen below the carrying book value, and thus becomes an impaired asset. (Write-Down Definition, 2020). The amount to be written down is the difference between the asset's book value and the amount of cash the business can acquire by disposing of it most optimally.

According to an article by a company's goodwill, accounts receivable, inventory, and long-term assets like property, plant, and equipment (PP&E) are the accounts that are most likely to be written down (Tuovila, 2020). When property, plant and equipment (PP&E) is impaired, it may be due to obsolescence, irreparable damage, or a decline in property value below its historical cost. It is common in businesses that produce or sell goods that require a stock of inventory that can become damaged or obsolete.

A write-down impacts the income statement and the balance sheet, and a loss is reported on the income statement. The write-down may be recorded as cost of goods sold (COGS) if the write-down is related to inventory. Otherwise, it is disclosed on the income statement as a distinct impairment loss line item so lenders and investors may evaluate the impact of depreciated assets.

The balance sheet asset's carrying value is reduced to its fair value. The impairment loss on the income statement reduces shareholders' equity on the balance sheet. In addition, because the write-down is not tax deductible until the concerned assets are actually sold or disposed of, an impairment may also result in the creation of a deferred tax asset or a decrease of deferred tax liability.

**2.2.8 Importance of recording non-cash expenses**

Non-cash expenses are recorded and recognized in the company's books of accounts and are shown in the income statements, which are either paid during any previous financial year or accrued expenses which will be paid in the future or arise due to any asset write-off etc. (Jain, 2022). These expenses reduce the amounts of profits generated and harm its profitability. It does not affect working capital for the accounting period since no cash payments are involved during the reported accounting period. In order to avoid window dressing by under- or overstating non-cash expenses in the company's income statement, management should analyze and appropriately record such non-cash expenses.

In the study "Non-Cash Expenses: Definition, Best Practices and Examples" (n.d.), states that it is crucial to include the non-cash expenses in the business's income statement after evaluating them. One of the three main financial performance statements that businesses create is the income statement. It shows the business's revenue, expenses, income, and losses. Recording non-cash expenses reduces the total income value that a company reports, which can also reduce its income for taxes.

Same source said that recording non-cash expenses can help business professionals, and leaders better understand the money available for company operations. An income statement that includes non-cash expenses can also give executives a more detailed view of a company's financial viability and long-term opportunities. Cash flow statements may not provide the same understanding since they only report the cash moving in and out of business. Recording non-cash expenses can also have the advantage of reducing a company's total taxable income.

It can be useful for bookkeepers to understand the distinction between their business' cash flow and its total income. Cash flow is a measurement of the amount of money that a company produces and spends. The total profit of a business after removing taxes, expenses, and interest are measured by net income. Non-cash expenses affect the company's total income since they do not require any financial outlay.

**3. METHODOLOGY**

The research design of this study is descriptive - qualitative in order to determine the methods used by the company's accounting or financial personnel in recording their non-cash expenses in the income statement. An open-ended question gave the respondents the opportunity to express their practices in a more detailed manner. Respondent companies were selected based on their proximity to the enumerators. Respondents were identified through their networks. However, only companies who were willing to disclose a portion of their financial information were selected. The respondents were initially briefed on the study's objectives and requested their verbal consent to use the information disclosed. Respondents included Finance officers, Comptrollers, Accountants, Accounting Manager, tax specialist, financial analyst, Asst. General Manager, and company owners. Data and responses were based on the company's 2020 and 2021 financial statements.

**4. RESULTS AND DISCUSSION**

Results and discussions based on the gathered data follow.

Table 1 shows the company profile. There were 15 respondent companies from various industries.

Table 1: Company Profile		
	No. of	Assets
Respondents	Years	in PhP
Leasing company	7	1,900,000
Services (Accounting)	20	8,000,000
Services (Leasing)	3	5,000,000
Services (Trading)	5	4,000,000
Mechanical Contracting	47	20,000,000
Construction (public roads)	5	9,500,000
Construction (residential, etc)	5	3,000,000
Travel Agency	21	70,000,000
Utilities	24	75,000,000
Radio and Television Broadcasting	60	12,100,000
Food and Beverage Manufacturing	69	99,000,000
Real Estate	15	100,000,000
Review Center	15	2,200,000
Trucking	3	1,000,000
Retail	3	2,500,000
Total	302	413,200,000
Average	20	27,546,667

The companies' number of years in the business ranges from 3 to 69 with an average of 20 years. Leasing, trucking, and retail have the lowest years in business, while food and beverages manufacturing have the longest year

of service. Their assets ranges from PhP1,000,000 to P100,000,000 with an average of PhP 100,000,000 which is within the classification of MSMEs.

The most common noncash expense, depreciation and bad debts are shown in Table 2.

**Table 2: Depreciation and Bad Debts, Methods of Computation**

	Depreciation	Depreciation		Basis of
For past two years (2020-2021)	Expenses	Methods	Bad Debts	Computation
Leasing Company	yes	Straight line	Yes	Actual
Services (Accounting)	yes	Straight line	Yes	Aging
Service (Leasing)	Yes	Straight line	None	None
Services (Trading)	Yes	Straight line	None	None
Mechanical Contracting	Yes	Straight line	Yes	% of Accounts
Construction (public roads)	Yes	Straight line	Yes	Actual
Construction (residential, etc)	Yes	Straight line	None	None
Travel Agency	Yes	Straight line	Yes	% of Sale
Utilities	Yes	Straight line	Yes	% of Accounts
Radio and Television Broadcasting	Yes	Straight line	None	None
Food and Beverage Manufacturing	Yes	Straight line	None	None
Real Estate	Yes	Straight line	None	None
Review Center	yes	Straight line	None	None
Trucking	yes	Straight line	None	None
Retail	yes	Straight line	None	None

Depreciation is recorded by all of the companies and shown in their income statements. All companies record their depreciation expenses using the straight-line method. In terms of bad debts, six (6) companies reported bad debts in 2020 and 2021. These companies are Leasing Company, Service (accounting), Mechanical Contracting, Construction (public roads), Travel Agency, and Utilities. The heaviest that suffered bad debts was the constructions of public roads. Construction of public roads is under the government program. The leasing company reports actual bad debts, while the accounting company uses aging to compute for bad

debts. Two companies (Mechanical contracting and Utilities) use % of accounts receivable, while one company (Travel Agency) uses % of sales. All other companies did not show bad debt expenses in their income statements for 2020-2021. BIR do not accept the estimated bad debts as part of the expenses. BIR considers the actual bad debts incurred by a company as an expense.

Computations for intangibles and other noncash expenses are shown in Table 3.

**Table 3: Intangible and Other Non-cash Expenses, Methods of Computation**

	Intangible	Basis of	Other Non-	Basis of
For past two years (2020-2021)	Assets	Computation	Cash Expenses	Computation
Leasing Company	None	None	None	None
Services (Accounting)	None	None	None	None
Service (Leasing)	None	None	None	None
Services (Trading)	Yes	SL Amortization	None	None
Mechanical Contracting	None	None	Yes	Actual
Construction (public roads)	None	None	Yes	Actual
Construction (residential, etc.)	None	None	None	None
Travel Agency	None	None	None	None
Utilities	Yes	SL Amortization	Yes	Actual
Radio and Television Broadcasting	Yes	Impairment	Yes	SL Amortization
Food and Beverage Manufacturing	Yes	Impairment	Yes	SL Amortization
Real Estate	Yes	SL Amortization	None	None
Review Center	yes	SL Amortization	None	None
Trucking	None	None	None	None
Retail	None	None	None	None

The companies that have intangible assets (goodwill, software cost, franchise, copyrights, trademarks) are Services (trading), Utilities, Radio and Television Broadcasting, Food and Beverages, Real Estate, and Review Center. Services (trading), Utilities, real Estate, and Review Center use amortization to compute for these intangibles, while Radio and Television Broadcasting and Food and Beverage Manufacturing use impairment method. Other noncash expense like research and development costs, Gain or loss on sale of fixed assets are reported by two companies. Both companies, Radio and Television Broadcasting and Food and Beverage Manufacturing use the straight-line amortization to report the expense.

Respondents were asked if they show noncash expense to suit their needs.

Only five companies (33.3%) show higher noncash expense to lower their taxes. These companies as shown in Table 4 are Service (trading), Constructions (residential, etc.) Travel Agency, Real Estate and Review Center. Likewise, four (4) companies (26.7%) reported lower noncash expense in 2020 and 2022 to show higher income for loan purposes. These companies belong to the Service (Trading), Construction (residential) Real Estate and the Review Center.

Other companies follow the general rule in reporting their noncash expenses. They believe that for income tax purposes, it is always more practical and righteous to reflect the correct non-cash expenses based on the policy or computation being maintained by each business to avoid

future tax assessments. These businesses declared transparently their actual incomes and expenses incurred for during the accounting period. This would give the respective businesses an actual view of the company's financial statement for decision-making purposes.

Table 4: Uses of Non-Cash Expense		
	Income Tax	Loan
For past two years (2020-2021)	Lower	Higher
Leasing Company	No	No
Services (Accounting)	No	No
Service (Leasing)	No	No
Services (Trading)	Yes	Yes
Mechanical Contracting	No	No
Construction (public roads)	No	No
Construction (residential, etc)	Yes	Yes
Travel Agency	Yes	No
Utilities	No	No
Radio and Television Broadcasting	No	No
Food and Beverage Manufacturing	No	No
Real Estate	Yes	Yes
Review Center	Yes	Yes
Trucking	No	No
Retail	No	No

### 5. SUMMARY OF FINDINGS AND RECOMMENDATIONS

All companies, regardless of their capital and asset size, must account for all expenses, cash or noncash.

- a. Different noncash expense accounts of the selected MSMEs are: Depreciation, bad debts, intangibles include goodwill, software cost, franchise, copyrights, and trademarks. Other noncash expense include research and development costs, Gain or loss on sale of fixed.
- b. MSMEs computation of noncash expense. Straight-line is the most common method for depreciation, while companies uses several methods for bad debts. Aging, percentage of sales and percentage of accounts receivable are used to estimate their bad debts. However, BIR mandates companies to declare their actual bad debts and use this as bad debts. Computation used for other intangibles and other noncash expense are straight-line and impairment.
- c. Five companies (33.3%) show higher noncash expense to lower their taxes while four (4) companies (26.7%) reported lower noncash expense to show higher income for loan purposes.

### 6. CONCLUSION

The study is exploratory and descriptive. It did not include an in-depth study of government rules and regulations. It is suggested that another study will be made which should include:

- i. BIR rules and regulations pertaining to noncash expenses.
- ii. Review of Accounting Standards on noncash expense
- iii. Use of quantitative method.

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