

Financial Reporting and Accounting Guide

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Expected credit loss impairment model

This publication provides a summary of the main features of the expected credit loss model in AASB 9 *Financial Instruments* relevant to accounting for trade receivables.

Background

One of the most significant changes to come into effect with the introduction of AASB 9 *Financial Instruments* is the expected credit loss model for impairment testing of financial assets. In contrast to its predecessor (the incurred credit loss model in AASB 139 *Financial Instruments: Recognition and Measurement*), AASB 9's expected credit loss model anticipates entities will recognise impairment losses in respect of their receivables before observable evidence exists of credit losses. Consequently, for some entities adopting the new impairment model in AASB 9 may necessitate them revisiting their past experiences and revising their current policies and procedures in relation to managing credit risks. However, for many entities their past policies, procedures and experiences may provide only limited assistance in applying the new credit loss model.

Like the incurred loss model in AASB 139, the expected credit loss model in AASB 9 comprises a set of principles and key components, rather than an explicit and detailed model, for identifying and measuring credit risks. The expected credit loss model in AASB 9, however, distinguishes itself from its predecessor in several important ways, including:

- providing practical expedients that will facilitate some entities tailoring their accounting policies and procedures in respect to measuring and accounting for credit risk; and
- incorporating several rebuttable presumptions that serve to constrain management's ability to defer the recognition of credit losses.

What instruments does the new impairment model apply to?

The new expected credit loss model applies to all debt instruments measured at amortised cost as well as to those measured at fair value through other comprehensive income in accordance with AASB 9. Consequently, trade receivables and most loans (including intercompany loans between group entities) will be subject to the new impairment model. The new model also applies to lease receivables, contract assets accounted for under AASB 15 *Revenue from Contracts with Customers*, loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss under AASB 9.

What are the main features of the new impairment model?

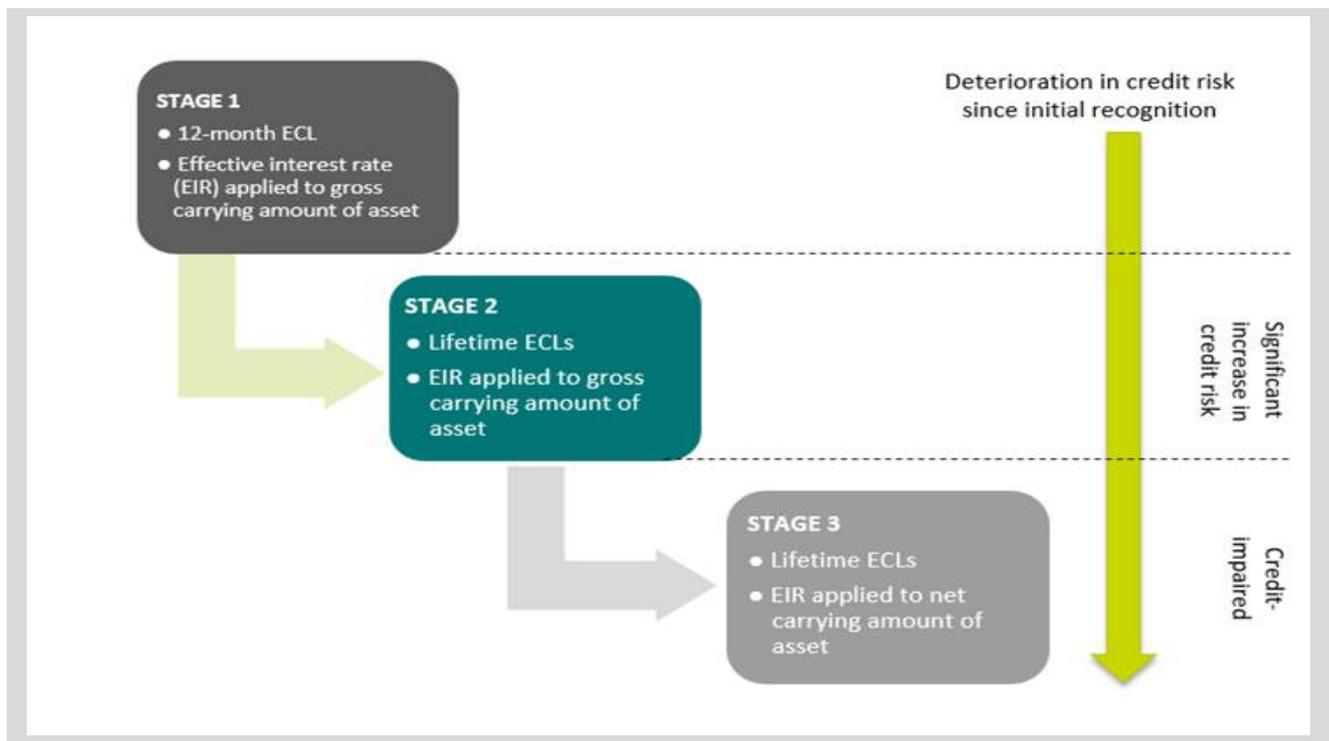
The purpose of the new expected credit loss model is to facilitate entities reflecting in their reported results the general pattern of deterioration (or, if applicable, improvement) in the credit quality of those financial instruments to which the model applies. To this end, AASB 9 provides two approaches for measuring expected credit losses (ECLs) – a general approach and a simplified approach.

The **general approach** involves an entity classifying the instruments that it holds and that are subject to the new model into one of three possible 'stages' of credit risk – 12-month ECLs, lifetime ECLs or credit impaired – and measure the ECLs and interest income attributable to each instrument (or group of instruments) consistent with the requirements applicable to the stage.

The **simplified approach** combines the first two stages of the general approach and consequently comprises only two stages – lifetime ECLs and credit impaired.

For many entities, the new expected credit loss model will principally apply to trade receivables. As discussed later in this publication, we anticipate that most entities will apply the simplified approach to their trade receivables, primarily because AASB 9 requires the simplified approach be applied to all trade receivables that do not have a significant financing component. Nevertheless, in explaining the general approach (as well as the simplified approach) the following discussion considers the implications of the general approach for debt instruments, including trade receivables.

The 3 stages of the 'general approach' are illustrated in the following diagram:



Each of the 3 stages of the 'general approach' is discussed below, followed by a brief outline of the 'simplified approach'.

The general approach – Stage 1

The diagram above provides an overview of how the general approach and the three stages of credit risk interact with respect to the measurement of ECLs.

Most entities, particularly those that have in place substantive credit risk management practices that they consistently enforce, would classify their debt instruments as Stage 1 on initial recognition. Such a classification implies that on initial recognition the instruments are not 'credit impaired' (discussed further below).

With respect to instruments classified as Stage 1:

- credit losses are the difference between all contractual cash flows that are due to the entity and all cash flows the entity expects to receive, discounted at the original effective interest rate (EIR); and
- 12-month ECLs are the ECLs that result from default events on the instrument that are possible within 12 months after the reporting date.

The concept of default is critical to the measurement of 12-month ECLs. AASB 9, however, doesn't define default; this is intentional.

Because credit risk and credit management arrangements can differ both across entities and over time, AASB 9 requires an entity to apply a default definition that is consistent with the definition the entity uses for internal credit risk management purposes for the instrument. AASB 9 also requires an entity to consider qualitative indicators, such as covenant breaches, when defining default, which suggests AASB 9 regards default as a broader concept than simply failure to pay.

Once an entity has defined what it regards as its default event (or events) with respect to a debt instrument, it measures its 12-month ECLs at the weighted average of the credit losses that result from the identified default event(s) that are possible within 12 months (with the respective risks of default occurring as weights). To this end, the measured amount of its ECLs would reflect the following measurement principles:

- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. Consequently, at a minimum, an entity would consider the probability that a credit loss would occur and the probability that no credit loss would occur, even if the probability of a credit loss occurring was very low;
- the time value of money;
- reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions; and
- unless the instruments include an undrawn commitment component, the maximum contractual period (including any extension options) over which the entity is exposed to credit risk.

As noted above, AASB 9 provides several practical expedients for measuring ECLs. One such practical expedient is the use of a provision matrix, which entities can apply provided that its use is consistent with the aforementioned measurement principles. The following example demonstrates how an entity might apply a provision matrix approach to measure its 12-month ECLs in respect to trade receivables.

Example 1

After establishing the customer's credit worthiness in accordance with its established credit risk management policies and procedures, on 1 July 2018 PP Ltd sold products worth \$3,650,000 on credit to Customer A. Based on experience and other information available, management of PP Ltd have concluded that days past due represent the best indicators of default.

Management also found that grouping trade receivables based on other customer attributes, such as product type or customer's geographical location, didn't necessarily improve the accuracy of PP Ltd's ECL calculations. Accordingly, management of PP Ltd estimated probability of default (POD) and loss given default (LGD) rates based on days past due using past credit experience and measured PP Ltd's 12-month ECLs with respect to Customer A as follows.

Past due status	POD	LGD	GCA	12-mth ECLs	Lifetime ECLs
Not past due	0.5%	8%	\$3,650,000	\$1,460	-
			\$3,650,000	\$1,460	-

POD: Probability of default

LGD: Loss given default

GCA: Gross carrying amount

ECLs = $POD \times LGD \times GCA$

As is evident from Example 1, in contrast to the approach under AASB 139 entities are now required to measure ECLs in respect to all debt instruments, including those for which there may be no observable evidence of credit losses.

It is also relevant to note that Example 1 doesn't explicitly incorporate the effects of the time value of money or future economic conditions in the measurement of ECLs. As trade receivables normally have a contractual life of less than 12 months, for Example 1 it was assumed that these factors do not have a material impact on the measured amount of the ECLs. These assumptions, however, may not always be appropriate, as discussed later in this publication.

When an entity initially measures a trade receivable classified at Stage 1 (or Stage 2) at its fair value (i.e., measures the receivable at the present value of its cash flows), any interest in respect to the receivable is measured by applying the EIR to the gross carrying amount of the receivable (rather than the net amount comprising the gross carrying amount less any applicable ECLs). For instance, in Example 1, if the receivable from Customer A had been initially discounted by the relevant EIR, interest revenue from the 'unwinding' of the receivable would be measure as follows:

$$\$3,650,000 \times \text{the original EIR \% per annum} \times \text{days past}/365$$

The general approach – Stage 2 (significant increase in credit risk subsequent to initial recognition)

For debt instruments that have experienced a 'significant increase' in credit risk (either on an individual or collective basis) since initial recognition, AASB 9 requires that the accompanying ECLs be measured at amounts equal to the lifetime ECLs attributable to those instruments.

Lifetime ECLs are calculated in the same way as 12-month ECLs (as the difference between all contractual and expected cash flows, discounted at the original EIR), but are determined based on the expected credit losses that result from all possible default events over the expected life of the instrument. Consequently, subject to the expected term and characteristics of a debt instrument, the amount of lifetime ECLs attributable to the instrument would be expected to equate with or exceed the amount of 12-month ECLs attributable to the same instrument.

AASB 9 provides the following principles that must be applied when considering whether a debt instrument has experienced a significant increase in credit risk:

- significance is assessed based on the change in the risk of default occurring over the expected life of the instrument rather than on the change in the amount of the accompanying ECLs. Consequently, a fully collateralised debt instrument may experience a significant increase in credit risk, notwithstanding that the expected loss given default is low and unchanged;
- at each reporting date compare the risk of default occurring over the expected remaining life of the instrument to the risk of default as at the date the instrument was initially recognised. Change in credit risk cannot be assessed by comparing the change in the absolute risk over time as the risk of default on a performing debt instrument typically decreases as the maturity date approaches; and
- consider all reasonable and supportable information that is available without undue cost or effort that is indicative of significant increases in credit risk since initial recognition.

To assist entities in identifying factors or indicators of a significant increase in credit risk, AASB 9 provides a non-exhaustive list that includes the following:

- existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the debtor's ability to meet its debt obligations;
- an actual or expected significant adverse change in the operating results of the debtor;
- an actual or expected significant adverse change in the regulatory, economic or technological environment of the debtor that results in a significant change in the debtor's ability to meet its debt obligations;
- significant changes, such as reductions in financial support from a parent, or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the debtor's economic incentive to make scheduled contractual payments;
- expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees; and
- past due information.

With regards to past due information, AASB 9 indicates that an entity should not solely rely on this type of information when determining whether credit risk has increased significantly since initial recognition. If, however, reasonable and supportable forward-looking information that is relevant to assessing whether there has been a significant increase in credit risk is not available (either on an individual or collective basis) to the entity without undue cost or effort, AASB 9 permits past due information to be used.

In addition, AASB 9 anticipates that past due information may be appropriate indicators of a significant increase in credit risk for debtors for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual level until the debtor breaches the contractual terms. Moreover, regardless of the way in which an entity assesses significant increases in credit risk since initial recognition, AASB 9 requires an entity to presume that:

- the credit risk on a debt instrument has increased significantly since initial recognition when contractual payments are more than 30 days past due ('30 days past due rebuttable presumption'); and
- default does not occur later than 90 days past due ('90 days past due rebuttable presumption');

unless the entity has reasonable and supportable information that supports a more lagged default indicator than 90 days.

The following example demonstrates how some of these principles and requirements might be applied in practice to trade receivables.

Example 2

Following on from the fact pattern provided in Example 1, as at 30 June 2019 PP Ltd has trade receivables of \$10 million. PP Ltd has many customers across a broad range of industries, each of which purchases a relatively small parcel of products from the entity. Accordingly, apart from past due information, PP Ltd has no other relevant and readily available information that it could use to assess whether any individual debtor, or all its debtors collectively, have experienced a significant increase in credit risk since initial recognition. Using POD and LGD rates based on past credit experience, management of PP Ltd measured the entity's 12-month and lifetime ECLs as follows.

Past due status	POD	LGD	GCA	12-mth ECLs	Lifetime ECLs
<30 days past due (incl. not past due)	0.5%	8%	\$8,655,000	\$3,462	–
31+ days past due	5%	15%	\$1,345,000	–	\$10,088
			\$10,000,000	\$3,462	\$10,088

POD: Probability of default

LGD: Loss given default

GCA: Gross carrying amount

ECLs = $POD \times LGD \times GCA$

In many cases, determining whether a change in credit risk is significant will require some judgement as to how the indicator will impact the credit risk of the debt instrument. To assist entities in making these judgements, AASB 9 provides several simplifications that can potentially streamline the assessment process, one of which is the 'low credit risk' rule.

If a debt instrument is assessed at any time as having 'low credit risk', the entity can assume no significant increases in credit risk have occurred. Such a classification not only relieves the entity from closely monitoring the credit worthiness of the debt instrument but also enables the entity to recognise 12-month rather than lifetime ECLs in respect to the instrument. A debt instrument is considered to have low credit risk if:

- the instrument has a low risk of default;
- the borrower has a strong capacity to meet its contractual cash flow obligations in the near term; and
- adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual obligations.

AASB 9 suggests a debt instrument with an external credit rating of 'investment grade' (for instance, a BBB S&P rating or a Baa3 Moody's rating) might be an example of an instrument with a low credit risk. AASB 9 does not require debt instruments to be externally credit rated to be classified as having low credit risk. However, an internal rating of low credit risk must be determined based on a methodology that is consistent with a globally understood definition of low credit risk and consider the risks and type of instrument being assessed. Consequently, the following characteristics would not, on their own, enable an instrument to be classified as having low credit risk:

- the instrument is secured by collateral that is more valuable than the instrument, particularly if in the absence of the collateral the instrument would not be considered to have low credit risk; and
- the instrument has a lower credit risk as compared to other instruments held by the entity, or lower credit risk relative to the credit risk of the jurisdiction within which the entity operates.

For many entities, particularly those whose main debt instruments are trade receivables, on its own the low credit risk simplification is unlikely to be applicable. If an entity's main debt instruments are trade receivables, the entity is unlikely to have in place an internal ratings system that is benchmarked against a globally understood definition of low credit ('investment grade') risk. Moreover, if the entity applies a provision matrix approach to measuring ECLs, in the absence of other systems to assess an individual debtor's capacity to withstand adverse changes in economic and business conditions in the future, it's unlikely the entity would be able to conclude that the associated debt instrument continues to be low credit risk.

AASB 9, however, does permit in some circumstances credit risk assessments to be made at the level of the counterparty. Accordingly, if a trade debtor has a recognised external credit rating, this could be used as a basis for assessing the level of credit risk attaching to the trade receivables attributable to the debtor. Nevertheless, it is important to note that AASB 9 only permits assessment of significant changes in credit risk at the counterparty (rather than the individual debt instrument) level if the outcome of the assessment would be the same had the financial instrument been assessed. That is, the credit risk of the debt instrument is substantially the same as the credit risk of the counterparty as a whole.

The general approach – Stage 3 (credit-impaired)

Debt instruments classified as Stage 3 under the general and simplified approaches are those that are 'credit-impaired', which means that in respect to the instrument one or more events that have a detrimental impact on the estimated future cash flows of the instrument have occurred. Examples of such detrimental events include:

- significant financial difficulty of the debtor;
- a breach of contract, such as a default or past due event;
- the debtor being granted a concession(s) that it would not otherwise be granted except for economic or contractual reasons relating to its financial difficulties; and
- it becomes probable that the debtor will enter bankruptcy or other financial reorganisation.

Accordingly, some entities might find when assessing whether a debt instrument is credit-impaired that they are using the same criteria they used under the incurred loss model in AASB 139 to identify 'incurred loss events'.

Upon classification of a debt instrument as credit-impaired an entity would continue to recognise lifetime ECLs in respect to the instrument. This, however, does not imply that the same quantum of ECLs would continue to be recognised. Subject to the definition of default used for debt instruments assessed as Stage 2, the nature of the event(s) that had a detrimental impact on the estimated future cash flows of the instrument, and available information about past events, current conditions and forecasts of future economic conditions, the entity might be expected to recognise larger ECLs in respect to a debt instrument classified as Stage 3 as compared to the ECLs recognised in respect to the same instrument when it was classified as Stage 2.

This is demonstrated in the example on the following page.

Example 3

Following on from the fact pattern provided in Example 2, as at 30 June 2020 PP Ltd has trade receivables of \$15 million. Over the past 12 months management of PP Ltd have reviewed the entity's credit risk management policies and procedures considering its debtor experiences and have identified additional categories of default based on days past due. Management have also reviewed estimated POD and LGD rates considering recently announced increases in unemployment rates relevant to the customers PP Ltd sells its goods and services to. In doing so, management have identified one debtor responsible for \$80,000 of the 91+ days past due balance at the last reporting date had applied for bankruptcy and that the full amount of the receivable was no longer recoverable. Using these revised categories, POD and LGD rates and information, management of PP Ltd measured the entity's 12-month and lifetime ECLs as follows.

Past due status	POD	LGD	GCA	12-mth ECLs	Lifetime ECLs
<30 days past due (incl. not past due)	0.5%	7%	\$6,350,000	\$2,223	–
31-60 days past due	4.5%	8%	\$3,280,000	–	\$11,808
61-90 days past due	6.5%	11%	\$2,200,000	–	\$15,730
91+ days past due	9.5%	30%	\$3,090,000	–	\$88,065
Credit-impaired			\$80,000	–	\$80,000
			\$15,000,000	\$2,223	\$195,603

POD: Probability of default

LGD: Loss given default

GCA: Gross carrying amount

ECLs = $\text{POD} \times \text{LGD} \times \text{GCA}$

Example 3 demonstrates several key principles underlying the expected credit loss model in AASB 9, including:

- debt instruments are required to be assessed as having experienced a significant increase in credit risk earlier than when they are assessed as either being in default or credit-impaired; and
- when an entity has no reasonable expectation of recovering the carrying amount of a debt instrument, the gross carrying amount of the financial asset should be written off.

When an entity classifies a debt instrument at Stage 3, any interest in respect to the instrument is measured by applying the EIR to the net carrying amount of the receivable (the gross carrying amount less any applicable ECLs). For instance, in Example 3, if during the reporting period ending 30 June 2020 the entity had classified the customer who subsequently applied for bankruptcy as Stage 3 and recognised interest in respect to the receivable during the reporting period, interest revenue from the 'unwinding' of the receivable would be measure as follows:

$$[\$80,000 - (\$80,000 \times 9.5\% \times 30\%)] \times \text{the original EIR \% per annum}$$

The simplified approach

AASB 9 distinguishes between debt instruments (and other items subject to the expected credit loss model, such as contract assets) that have a significant financing component and those that do not and requires the 'simplified approach' be applied to those debt instruments that do not have a significant financing component. For those debt instruments that do have a significant financing component (as well as lease receivables), AASB 9 permits entities to apply either the simplified approach or the general approach.

AASB 15 (rather than AASB 9) explains that a 'significant financing component' exists when the timing of payments agreed to by the parties to a contract (either explicitly or implicitly) provides one of the parties with a significant benefit of financing. In determining whether an arrangement includes a significant financing component, an entity would consider all relevant facts and circumstances, including both of the following:

- (a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and
- (b) the combined effect of both the following:
 - (i) the expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods and services; and
 - (ii) the prevailing interest rates in the relevant market.

For trade receivables less than 12 months, particularly those with 30-60-day payment terms, unless the prevailing market interest rates are relatively high, it might be assumed that credit arrangements do not have a significant financing component.

Under the simplified approach an entity would determine the ECLs for its debt instruments (either on an individual or a collective basis) in the same manner as it would under the general approach, except that:

- the loss allowance would be determined based only on lifetime ECLs; and
- the time value of money would be ignored.

For many entities, whether they apply the simplified or general approach is unlikely to have a material impact on the quantum of the ECLs they recognise in respect to their trade receivables. When the expected term of a debt instrument is less than 12 months, 12-month and lifetime ECLs will be the same. Nevertheless, AASB 9 requires the simplified approach for measuring ECLs to be applied to all trade receivables that do not have a significant financing component.

Further information and assistance

Contact Pitcher Partners for further information and assistance on AASB 9 and its expected credit loss model.

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