

# Financial Reporting and Accounting Guide

June 2023

## ***Applying the expected credit loss impairment model to trade receivables***

This publication provides a high-level summary of the application of the 'simplified approach' for recognising expected credit losses under AASB 9 *Financial Instruments* (AASB 9) to trade receivables.

When applying the 'simplified approach' to trade receivables, an entity is required to recognise an allowance for the estimated amount of lifetime expected credit losses (ECLs). AASB 9 defines 'lifetime ECLs' as those that result from all possible default events over the expected life of the financial instrument.

To this end, although there are no prescribed techniques or methods for the measurement of ECLs, an entity is required to measure ECLs in a way that reflects:

- 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; and
- 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.

One common approach for the measurement of lifetime ECLs of trade receivables is the 'loss rate approach'.

Under the 'loss rate approach', an entity develops an expected loss rate, based on its historical credit loss experience, as well as current conditions and forecasts of future economic conditions that are relevant to an assessment of the ability of customers to settle their outstanding accounts. The expected loss rate is then used to calculate an allowance for ECLs, to be recorded against year-end trade receivables.

The key steps of the 'loss rate approach' are:

- 1) Establish appropriate groupings of customer accounts according to shared credit risk characteristics.
- 2) Determine historical loss rates (for each grouping).
- 3) Consider forward-looking information (and adjust historical loss rates as appropriate).
- 4) Calculate an allowance for ECLs (for each grouping) using an expected loss rate.

Each of these steps is discussed below.

### **Step 1: establish appropriate groupings of customer accounts according to shared credit risk characteristics**

When estimating ECLs, AASB 9 permits an entity to group customer accounts on the basis of shared credit risk characteristics. An allowance for ECLs is then calculated separately for each grouping. Importantly, customers with significantly different historical credit loss experiences cannot be included in the same group. Examples of criteria that might be used to group customer accounts include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer.

## Step 2: determine historical loss rates (for each grouping)

The historical loss rate is determined by selecting an appropriate population of past credit sales (i.e., past sale transactions that exposed the entity to credit risk) and identifying the total credit losses that resulted from those credit sales. The loss rate is the total credit losses as a percentage of the total credit sales for that population.

The historical loss rate needs to be determined for each grouping identified in Step 1.

When selecting an appropriate population of past credit sales, one important consideration is the length of the time period. E.g., 2 years, 5 years or longer than 5 years? The time period should be long enough to identify loss patterns, but not too long such that the identified loss patterns are not reflective of current conditions or not relevant to the future period over which trade receivables will be collected.

Determining the historical loss rate is illustrated in Example 1.

### Example 1

Entity X recorded \$30 million of credit sales (i.e., sale transactions that exposed the entity to credit risk) during the 2-year period from 1 January 2021 to 31 December 2022. Entity X determined that the total credit losses arising from this population of credit sales was \$450,000. Using this historical data, Entity X determined the historical loss rate as follows.

Historical period	Total credit sales	Total credit losses	Historical loss rate
1 Jan 21 to 31 Dec 22	\$30,000,000	\$450,000	1.5%

## Step 3: consider forward-looking information (and adjust historical loss rates as appropriate)

In addition to looking at past events (e.g., historical loss rates), AASB 9 requires an entity to consider information available without undue cost or effort at reporting date about current conditions and forecasts of future economic conditions.

The impact of current conditions and forecasts of future economic conditions needs to be considered separately for each grouping identified in Step 1.

It may be necessary to adjust the historical loss rates determined in Step 1:

- 1) To reflect the effects of current conditions and forecasts of future economic conditions that did not affect the period on which the historical data is based.
- 2) To remove the effects of conditions that existed in the historical period that are not relevant to the future period over which trade receivables will be collected.

The information used shall include factors that are specific to the customer, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at reporting date.

In some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the customer accounts being considered.

Consideration of current conditions and forecasts of future economic conditions is illustrated in Example 2.

### Example 2

Following on from the fact pattern provided in Example 1, Entity X's management considers the available data on customer payment patterns subsequent to 31 December 2022 (i.e., after the end of the historical period). Analysis of this data does not identify payment patterns that differ significantly from the historical average. In addition, available data on the direction of economic conditions for the sector indicates that economic conditions are likely to remain steady for the short to medium term.

On the basis of the available data, management concludes that the historical loss rate of 1.5% does not require adjustment. Accordingly, an expected loss rate of 1.5% will be used for the calculation of ECLs at 30 June 2023.

#### Step 4: calculate an allowance for ECLs (for each grouping) using an expected loss rate

The calculation of an allowance for ECLs, to be recorded against year-end trade receivables, needs to be undertaken separately for each grouping identified in Step 1, using each grouping's expected loss rate.

As the expected loss rate reflects expected credit losses as a percentage of credit sales (as distinct from a percentage of trade receivables at a point in time), when calculating an allowance for ECLs, the expected loss rate is not applied directly to year-end trade receivables. Instead, the expected loss rate is used to calculate an allowance for ECLs by applying either of the following common approaches:

- Approach A: apply the expected loss rate to the population of credit sales of which unpaid invoices (from that population) are included in the year-end trade receivables (illustrated in Example 3); or
- Approach B: use the expected loss rate and the historical ageing (cash collection pattern) of trade receivables to determine an expected loss rate per ageing band, and then apply the expected loss rate per ageing band to the balance of each ageing band for year-end trade receivables (illustrated in Example 4). This approach is referred to in AASB 9 as a provision matrix.

Entities should select an approach to calculating an allowance for ECLs that works best for each grouping, based on the specific nature and circumstance, and available data, of each grouping.

In practice, the estimated allowance for ECLs under one approach will almost always differ in amount from the estimate made under the alternative approach. However, the outcome of each approach should not differ significantly, as the estimates are each based on the application of the same expected loss rate.

#### Example 3

*Approach A: applying the expected loss rate directly to the population of credit sales.*

Following on from the fact pattern provided in Examples 1 and 2, at 30 June 2023, Entity X has trade receivables of \$1,634,000 (before any allowance for ECLs). The year-end trade receivables relate to invoices issued by Entity X in February, March, April, May and June 2023, which in total amounted to \$3,682,000.

Credit sales (Feb 2023 to June 2023): \$3,682,000

Receipts from customers: \$2,048,000

Trade receivables at 30 June 2023: \$1,634,000

Entity X has not written off any outstanding balances from this population.

Applying the expected loss rate of 1.5% (from Example 2) to the population of credit sales of which unpaid invoices are included in the year-end trade receivables, Entity X estimates an allowance for ECLs as follows.

Population of credit sales (with unpaid invoices included in the year-end trade receivables)	Expected loss rate	Allowance for ECLs
\$3,682,000	1.5%	\$55,230

As illustrated in Example 3, by applying the expected loss rate directly to the population of credit sales of which unpaid invoices (from that population) are included in the year-end trade receivables, Entity X records an allowance for ECLs of \$55,230 against trade receivables at 30 June 2023.

Because the allowance for ECLs is estimated by applying the expected loss rate directly to the relevant population of credit sales, this approach doesn't require consideration of the historical average ageing of trade receivables, or the actual ageing of year-end trade receivables.

#### Example 4

*Approach B: using the expected loss rate and the historical ageing (cash collection pattern) of trade receivables to determine an expected loss rate per ageing band (provision matrix approach).*

Using the same fact pattern provided in Example 3, Entity X uses the expected loss rate and the historical ageing (cash collection pattern) of trade receivables to determine the following expected loss rates per ageing band:

Current:	1.5%
1-30 days past due:	3.02%
31-60 days past due:	7.90%
More than 60 days past due:	27.75%

Applying the expected loss rates per ageing band to the balance of each band for year-end trade receivables, Entity X estimates an allowance for ECLs as follows.

Ageing at 30 June 2023	Balance outstanding at 30 June 2023	Expected loss rate per ageing band	Allowance for ECLs
Current	\$962,000	1.50%	\$14,430
1-30 days past due	\$455,000	3.02%	\$13,725
31-60 days past due	\$167,000	7.90%	\$13,200
More than 60 days past due	\$50,000	27.75%	\$13,875
	<b>\$1,634,000</b>		<b>\$55,230</b>

As illustrated in Example 4, by using the expected loss rate and the historical ageing (cash collection pattern) of trade receivables to determine an expected loss rate per ageing band, and then applying the expected loss rate per ageing band to the balance of each ageing band for year-end trade receivables, Entity X records an allowance for ECLs of \$55,230 against trade receivables at 30 June 2023.

Although this approach doesn't require consideration of the underlying population of credit sales that gives rise to year-end trade receivables, it does include the added step of converting the average expected loss rate to an expected loss rate per ageing band (using the historical ageing (cash collection pattern)).

### Further information and assistance

Contact Pitcher Partners for further information and assistance on the application of the impairment requirements of AASB 9 to trade receivables.

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