Pitcher Partners

Financial Reporting and Accounting Guide

June 2023

Expected credit loss impairment model – 'general approach'

This publication provides a high-level summary of the main features of the 'general approach' for recognising expected credit losses under AASB 9 *Financial Instruments* (AASB 9).

Scope and objective

The impairment requirements of AASB 9 apply primarily to debt instruments measured at amortised cost, such as loan balances, trade receivables and lease receivables, and debt instruments measured at fair value through other comprehensive income.

An entity is required to recognise expected credit losses for those financial assets that are subject to the impairment requirements of AASB 9 from the date of initial recognition of the financial asset and throughout the life of financial asset (i.e., until derecognition of the financial asset).

What are 'credit losses' and 'expected credit losses'?

A **'credit loss'** is the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit impaired financial assets).

When measuring a 'credit loss', an entity is required to estimate cash flows by considering all contractual terms of the financial instrument (e.g., prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows considered, when measuring a 'credit loss', include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms.

'Expected credit losses' (ECLs) are the weighted average of 'credit losses' with the respective risks of a default occurring as the weights.

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.

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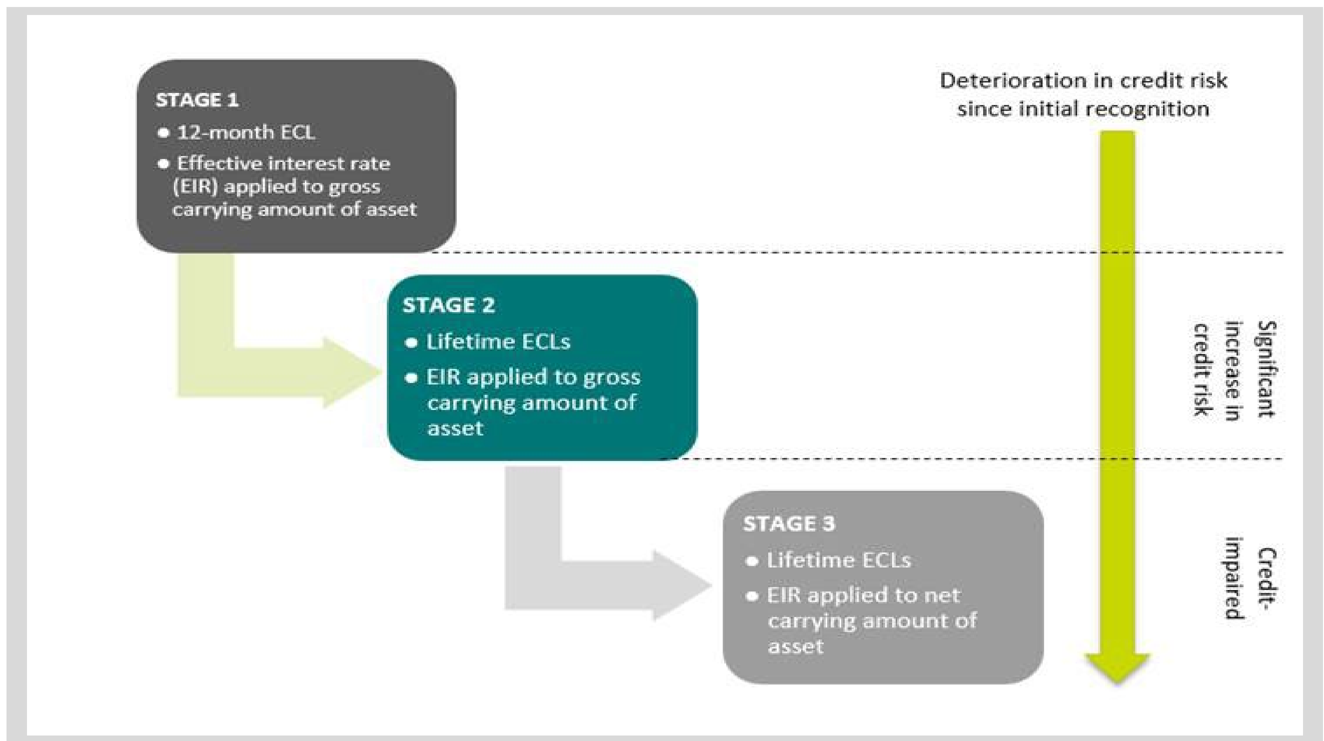
What is the required approach for measuring ECLs?

AASB 9 provides two approaches for measuring ECLs:

- the 'general approach'; and
- the 'simplified approach'.

The **general approach** involves an entity classifying financial assets (that are subject to the impairment requirements of AASB 9) into one of three possible 'stages' of credit risk – 12-month ECLs, lifetime ECLs or credit impaired – and measure the ECLs and interest income consistent with the requirements applicable to the stage.

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



The **simplified approach** combines the first two stages of the general approach and consequently comprises only two stages – lifetime ECLs and credit impaired. The simplified approach must be applied to trade receivables and contract assets (that result from transactions within the scope of AASB 15 *Revenue from Contracts with Customers*) that **do not** contain a significant financing component. In addition, an entity can choose to apply the simplified approach to trade receivables and contract assets that **do** contain a significant financing component, and also to lease receivables (that result from transactions within the scope of AASB 16 *Leases*).

A high-level summary of the main features of the 'simplified approach' for the recognition of ECLs is contained in a separate Financial Reporting and Accounting Guide - *Applying the expected credit loss impairment model to trade receivables*.

What are the 3 stages of the general approach

The diagram above provides an overview of how the general approach and the 3 stages of credit risk interact with respect to the measurement of ECLs.

Each of the 3 stages of the general approach is discussed below.

Stage 1 (initial recognition or no significant increase in credit risk subsequent to initial recognition)

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.

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With respect to debt 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; 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 after the reporting date (with the respective risks of default occurring as weights). 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;
- 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.

One common approach to estimate 12-month ECLs is the 'probability of default approach'.

This approach is illustrated in Example 1.

Example 1

After establishing the customer's credit worthiness in accordance with its established credit risk management policies and procedures, on 1 July 2022 PP Ltd provided loan funding of $3,650,000 to Customer A. The term of the loan is 5 years and the effective interest rate is 5.5%. Interest is payable monthly.

At reporting date (30 June 2023), PP Ltd assesses that the loan is classified as 'Stage 1' under the 'general approach' (i.e., PP Ltd has assessed that credit risk has not increased significantly since initial recognition). Accordingly PP Ltd is required to recognise 12-month ECLs as an allowance against the carrying amount of the loan at 30 June 2023.

'12-month ECLs' are those ECLs that result from default events that are possible within 12 months after reporting date.

PP Ltd has estimated the exposure at default (EAD), the probability of default (POD) and the loss given default (LGD) using its past credit experience and consideration of appropriate forward looking information. Using those inputs, PP Ltd has estimated 12-month ECLs as follows.

Exposure at default (EAD)[i]	Probability of default (POD)	Loss given default (LGD)	12-month ECLs[ii]
$3,650,000	0.5%	20%	$3,650

(i) The estimated amount of the exposure at default (EAD) takes into account expected changes in the carrying amount of the loan balance subsequent to reporting date, including payments of principal and interest.

(ii) For the purpose of the illustrative example, the calculation of 12-month ECLs excludes the impact of the time value of money.

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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. These debt instruments are classified as 'stage 2' under the 'general approach'.

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 effective interest rate), 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.

Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due.

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The calculation of lifetime ECLs using the ‘probability of default approach’ is illustrated in Example 2.

Example 2

Following on from the fact pattern provided in Example 1, at the following reporting date (30 June 2024), PP Ltd assesses that the loan is classified as ‘Stage 2’ under the ‘general approach’ (i.e., PP Ltd has assessed that credit risk has increased significantly since initial recognition). Accordingly, PP Ltd is required to recognise lifetime ECLs as an allowance against the carrying amount of the loan at 30 June 2024.

‘Lifetime ECLs’ are those that result from all possible default events over the expected life of the loan. At reporting date (30 June 2024), the remaining period to maturity is 3 years.

PP Ltd has estimated the exposure at default (EAD), the probability of default (POD) and the loss given default (LGD) using its past credit experience and consideration of appropriate forward looking information. Using those inputs, PP Ltd has estimated lifetime ECLs as follows.

Time period	Exposure at default (EAD)[i]	Probability of default (POD)	Loss given default (LGD)	Effective interest rate (EIR)	ECLs[ii]
0 to 1 year	$3,650,000	1.0%	25%	5.5%	$8,919
1 to 2 years	$3,650,000	1.5%	25%	5.5%	$12,664
2 to 3 years	$3,650,000	1.7%	25%	5.5%	$13,586
Lifetime ECLs:					$35,169

(i) The estimated amount of the exposure at default (EAD) takes into account expected changes in the carrying amount of the loan balance subsequent to reporting date, including payments of principal and interest.

(ii) ECLs for each time period are calculated on a present value basis using the effective interest rate and the assumed date of default. This example assumes that the date of default is the mid-point of each financial year (i.e., 6 months, 18 months and 30 months).

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.

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Stage 3 (credit-impaired)

Debt instruments classified as 'Stage 3' under the 'general approach' are those that are 'credit-impaired', which means that one or more events have occurred that have a detrimental impact on the estimated future cash flows of the instrument.

Evidence that a financial asset is credit-impaired include observable data about the following events:

- significant financial difficulty of the issuer or the borrower;
- a breach of contract, such as a default or past due event;
- the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
- it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses. It may not be possible to identify a single discrete event – instead, the combined effect of several events may have caused financial assets to become credit impaired.

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 allowance for ECLs recognised for a debt instrument classified as Stage 3 may differ from the amount recognised for the same instrument when it was classified as Stage 2.

In addition to the calculation of ECLs, when debt instruments are classified as 'stage 3' under the 'general approach', interest revenue is calculated by applying the effective interest rate to the net carrying amount of the debt instrument (i.e., net of the allowance for ECLs), instead of the gross carrying amount.

Further information and assistance

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

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