IFRS 9: Lifetime Expected Credit Losses for Trade Receivables

Extract, IFRS® Discussion Group Report on the Meeting – June 21, 2018

IFRS 9 *Financial Instruments* changes the way that entities are required to apply provisions against trade receivables measured at amortized cost or at fair value through other comprehensive income. The model in IFRS 9 is forward-looking – meaning that entities are required to not only focus on whether a loss has occurred, but also whether a loss might occur in the future. This model is referred to as the "expected credit loss model".

The Group discussed eight questions to highlight some of the factors to consider when applying the expected credit loss model to trade receivables.

Question 1 – Can expected credit losses be immaterial or even negligible, but never nil?

Expected credit losses are calculated in a mathematical sense. This means that there will always be some chance that cash flows will fall short of the contractual amounts. Hence, expected credit losses can never be nil.

The Group's Discussion

From a mathematical perspective, the model in IFRS 9 for calculating expected credit losses is based on taking the "probability of default", and multiplying it by the "loss given default" and the amount of "exposure at default". The effects of this multiplication could be that expected credit losses are small or close to nil.

One Group member thought that there could be situations, albeit rare, that expected credit losses could actually be nil (e.g., a 30-day receivable with a government agency that has a very strong credit rating). However, a few other Group members noted that even with sovereign nations, there is typically a probability of default notwithstanding that it could be low. Also, the probability of default could vary depending on the duration of the financial instrument.

The Group also talked about a situation involving a highly collateralized financial instrument. Although such an instrument may still have a probability of default, there is enough collateral to absorb the loss so that the measurement of expected credit losses could be nil. However, for trade receivables, it is typically not common to have collateral backing the instrument. An entity may also have a general security agreement over the assets and having such an agreement could lead to the loss given default in that situation to be zero.

Group members observed that in applying the impairment model in IFRS 9, even if expected credit losses are determined to be negligible or nil, it is important that entities are able to demonstrate that they have done enough work to ascertain that outcome. This work includes ensuring sufficient controls are in place that would support an assessment of negligible or nil because credit risk factors can change over time.

Source: www.frascanada.ca/archive-meeting-reports

Question 2 – What are some methods used to develop provision matrices?

IFRS 9 mandates a simplified approach to implementing an expected credit loss model for trade receivables without a significant financing component. Trade receivables with terms of one year or less would generally not have a significant financing component. An entity calculates the lifetime expected credit losses as its provision against such receivables.

Illustrative Example 12 in IFRS 9 discusses the use of a provision matrix as one possible way to implement the simplified approach. A provision matrix essentially applies an expected credit loss rate to every aging category of receivables, including the "current" category (see example below).

	Current	**1-30 days past due**	**31-60 days past due**	**61-90 days past due**	**More than 90 days past due**
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

	Gross carrying amount	**Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)**
Current	CU15,000,000	CU45,000
1-30 days past due	CU7,500,000	CU120,000
31-60 days past due	CU4,000,000	CU144,000
61-90 days past due	CU2,500,000	CU165,000
More than 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	**CU580,000**

IFRS 9 requires all categories of receivables to have a provision, even when they are not past due. The gross carrying amount of the receivables would be written off when the entity has no reasonable expectation of recovering anything for the financial asset. An entity should consider whether any receivables in the category of more than 90 days past due should be written off.

The expected credit loss model also applies to contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers*, such as accruals of revenue or certain variable consideration. Therefore, the model applies even before a customer is invoiced.

In developing a provision matrix, an entity could consider doing the following:

- Gather information on the history of uncollectible amounts.
- Stratify receivables into different groups or segments before applying the provision matrix (e.g., by geographical regions, product type, customer ratings, collateral, and the nature of the customer such as wholesale versus retail). Proper stratification requires understanding the drivers of credit risk for underlying receivables. The stratification may go down to the individual customer level in some cases, but it is important to avoid double counting of losses in these situations.

- Understand the percentage of sales that historically makes its way to the category in which losses are typically experienced (such as the “more than 90 days past due” category) and the percentage that is lost from such receivables.
    - For example, an entity might conclude that 1 per cent of its sales will migrate to the “more than 90 days past due” category, and that, historically, 30 per cent of the face value of accounts in default is not collected. This historical pattern would imply that the starting point for the first aging category is 30 per cent x 1 per cent = 0.3 per cent. In other words, historically, 0.3 per cent of the dollar amount in current receivables has not been collectible. This same thought process is applied to each aging category to determine the historical loss ratio.

Establishing the historical loss rate is only the starting point. Entities also need to consider whether there is a long enough history and the historical data is similar enough to the current stratification criteria to assert that historical losses are a valid representation of the loss pattern.

The Group’s Discussion

The Group supported the analysis above in that provision matrices are developed by considering historical credit loss experience and aging history, and stratifying trade receivables based on factors that drive credit risk (e.g., industry, geographical regions, product type, customer ratings, collateral, and the nature of the customer such as wholesale versus retail).

Group members observed that materiality is a key factor considered by entities when deciding on how sophisticated the provision matrix must be for calculating expected credit losses. Several Group members noted that in practice, some entities have determined that regardless of how the population of trade receivables is stratified or segmented, the expected credit losses would not be material. As a result, a basic provision matrix such as the one shown in IFRS 9 is used.

Another Group member shared that in the banking industry, a roll-rate model is used for credit cards. The model takes into consideration terms of maturity and supplements the historical loss rate with forward-looking information. For trade receivables with typically a short term, a simple provision matrix may be sufficient. However, for longer-term items, the provision matrix will have to be more sophisticated to take into consideration other factors that would also drive credit risk.

Next, the Group discussed Questions 3 and 4 together.

Question 3 – Do entities look to external data in deriving the expected credit loss rate?

A newly established entity or an entity entering a new market may need to look to more than its own experience when determining expected credit losses. For example, an entity historically operating in North America but expanding to Europe may not be able to rely on its historical North American loss rates for its European receivables. In such situations, the entity might consider industry loss rates instead.

Question 4 – How do entities incorporate forward-looking information into their provision matrices, and have entities used scenario analyses?

The question is how or to what extent the expected credit loss rate should be adjusted for differences between historical experience and future expectations. For example, an entity may look for a historical correlation between unemployment rates and the loss rate experience. If it finds such a correlation, an adjustment would need to be made to the historical rates to reflect the change in the forecasted unemployment rate.

It is important to note that establishing a linkage to macro-economic data has its complexities due to a potential lag in effect. For example, a rise in unemployment rate may not trigger an immediate increase in default for an electrical utility's customers because customers may prioritize paying electricity bills over other discretionary expenditures. Perhaps a prolonged period of increased unemployment may trigger a rise in loss rates. Therefore, such factors should be considered in the correlation analysis.

Entities might use scenario analyses to reflect different possible future outcomes for the correlated variable. Such adjustments to historical data are important because IFRS 9 does not rely exclusively on historical loss rates. It also requires informed estimates about the future.

The Group's Discussion

Several Group members observed that entities look at external data when calculating expected credit losses for trade receivables.

One Group member noted that segmentation of the trade receivables population is important, especially when the entity has long-term contracts in which the contract asset or the customer receivable is quite large. In such cases, performing an analysis by customer, including looking at the customer's credit rating or business operations, may be required to determine whether a larger expected credit loss amount should be recognized. Even if historical information indicates that losses have not been material, entities should incorporate forward-looking information and consider whether there are macro-economic factors that could suggest the industry has changed, such that relying on historical information is not sufficient.

Another Group member noted that some entities may use different loss rates based on the current economic environment (e.g., low-volatility versus high-volatility markets).

There could also be industries in which historical information is less relevant. For example, one Group member noted that for agricultural products, the prevailing commodity price is relevant in predicting the ability to collect from customers. Also, external factors such as weather could affect collectability, so those types of external data would be taken into consideration when designing the provisional matrix.

The Group noted that even when the history of losses is negligible, entities still need to consider forward-looking factors to demonstrate that the expected credit losses remain immaterial, for consistency with the underlying forward-looking impairment model in IFRS 9.

Next, the Group discussed Questions 5 to 8 together.

Question 5 – Are there other methods of implementing the simplified approach in practice?

Although IFRS 9 provides an example of a provision matrix, other methods are not precluded.

Question 6 – What are some additional considerations that entities should be aware of when implementing the simplified approach?

When looking at historical data, it is important to segregate losses relating to customer disputes or other discounts provided, from credit losses. Only losses due to credit risk would be within the scope of the IFRS 9 impairment provision. Other losses due to disputes, discounts, and/or inefficiencies are subject to guidance in IFRS 15, which should be applied prior to IFRS 9.

For income statement presentation, adjustments required under IFRS 15 will directly affect the revenue line, whereas IFRS 9 impairment provisions will generally affect an expense line.

Entities that have not historically tracked credit losses separately from other losses may need to re-examine the way data is collected and tracked to simplify the application of the provision matrix.

Incomes taxes may also be affected by the change in methodology for impairment as this change could create new or additional temporary differences.

Question 7 – Are entities experiencing any challenges with meeting the disclosure requirements for the expected credit loss model?

As a result of IFRS 9, IFRS 7 *Financial Instruments: Disclosures* requires more extensive disclosure about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses. Paragraph 35N of IFRS 7 allows entities to disclose some of the information based on the provision matrix when that simplified approach has been used.

Entities need to ensure their systems and processes are capable of generating the required quantitative information for the required disclosures.

Question 8 – Are entities experiencing any challenges when implementing controls pertaining to the simplified approach?

Since the IFRS 9 impairment model is substantially different from the IAS 39 impairment model and requires different estimates and judgments to be applied, new and different internal control procedures may be required.

Some controls may need to be implemented outside the financial reporting function (e.g., in the collections or credit management group) and systems may need to be changed to generate new analytical reports for deriving the required estimates of expected credit losses.

Also, controls might need to involve backward testing over time to compare between experienced losses and established provisions. This testing will help determine whether changes to the provisioning methodology, such as additional correlations to macro-economic indicators or enhanced segmentation of customers, are required.

The Group's Discussion

Several Group members shared insights relating to the four questions above.

In terms of other methods of applying the simplified approach, an entity could adopt a specific-customer approach instead of developing a provision matrix, if it transacts with a small group of customers.

In terms of implementing the simplified approach, one of the challenges noted relates to distinguishing credit losses from losses due to customer disputes because this information was not previously tracked by entities. It is important to note that losses due to credit risk are separated from other losses because only credit losses are within the scope of IFRS 9.

To date, no significant disclosure challenges have been identified because most entities have only reported their first quarter financial statements under IFRS 9. The interim financial statements have only disclosed a description of the entity's accounting policy for expected credit losses.

From a controls perspective, entities are reminded to ensure that even if the expected credit losses for trade receivables are determined to be immaterial, proper controls need to be in place to ensure that changes in circumstances can be detected before a loss is incurred.

Overall, the Group discussed this topic to raise awareness of factors to consider under the new impairment model in IFRS 9 for trade receivables. The intent of the Group's discussion was to share insights on what approaches and challenges have been observed in practice. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).