Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.

Practical challenges of applying the IFRS 9 impairment model to trade and lease receivables

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In July 2014, the International Accounting Standards Board (IASB) published IFRS 9 *Financial Instruments* (2014) which was subsequently released in Australia as AASB 9 (2014). This standard introduces an expected credit loss (ECL) impairment model that applies to financial instruments, including trade and lease receivables. AASB 9 (2014) applies to annual periods beginning on or after 1 January 2018.

While the main reason for amending the current model was to require major banks to recognise losses in advance of a credit event occurring, this new model also applies to all receivables, including trade receivables, lease receivables, intercompany/related party loan receivables etc.

The new impairment model is intended to result in earlier recognition of credit losses. The resulting increase in doubtful debt provisions may have a flow on effect for loan covenants, bonuses, and reported earnings amongst others.

This article focusses on the practical challenges facing entities with trade and lease receivables when implementing the new impairment model.

Overview of the IFRS 9 Impairment Model

In contrast to the current 'incurred loss' model in AASB 139 *Financial Instruments: Recognition and Measurement*, the new impairment model is forward looking and no longer requires a credit event (e.g. a payment being overdue) to have occurred before credit losses are recognised. To some this may appear to be 'back to the future' because the model effectively requires 'general doubtful debt provisions' to be recognised based on the likelihood of a receivable going 'bad', something that was often done prior to the introduction of IFRS in 2005.

The full IFRS 9 impairment model is based on changes in expected credit losses and involves a three stage approach. Expected credit losses are determined as follows at the end of each reporting date:

- Stage 1: Credit risk has not increased significantly since initial recognition – recognise 12 months of ECL
- Stage 2: Credit risk has increased significantly since initial recognition – recognise lifetime

ECL, and interest is presented on a gross basis

- Stage 3: Financial asset is credit impaired (using the criteria currently included in AASB 139) – recognise lifetime ECL but present interest on a net basis (i.e. gross carrying amount less credit allowance).

The recognition of impairment (and interest revenue) is summarised below:

Stage	1	2	3
Recognition of Impairment	12 month expected credit loss	Lifetime expected credit loss [(b)]	
Recognition of Interest	Effective interest on the gross amount		Effective interest on the net (carrying) amount

Figure 1 – Summary of the recognition of impairment (and interest revenue) under IFRS 9

However as a practical expedient, a 'simplified' model applies for trade receivables with maturities of less than 12 months. For other long term trade and lease receivables (i.e. trade and lease receivables with maturity of longer than 12 months), entities have a choice to either apply the 'full' three stage model or the 'simplified' model.

Implications for entities with short term trade receivables

The two key differences for trade receivables between the current impairment model under AASB 139 and the new 'simplified' model are:

- An entity does not wait until the receivable is past due before a provision is raised, and
- The amount of credit loss recognised is based on forward looking estimates that reflect current and forecast credit conditions.

Under the 'simplified' approach, entities with short term trade receivables will recognise 'lifetime expected credit losses' from the first reporting period. These are the credit losses expected over the term of the receivable. In practice, this closely resembles the 'general' doubtful debt provisioning methods used prior to the adoption of IFRS in 2005!

The new impairment model allows entities to calculate expected credit losses on trade receivables using a provision matrix. In practice, many entities estimate credit losses using a provision matrix where trade receivables are grouped based on different customer attributes and different historical loss patterns (e.g. geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer). Under the new model, entities will update their historical provision rates with current and forward looking estimates.

Example: Short term trade receivables

- Company M has a portfolio of trade receivables of $30 million at 31 December 2014.
- The customer base consists of a large number of small clients.
- To determine the expected credit losses for the portfolio, Company M uses a provision matrix.
- The provision matrix is based on its historical observed default rates, adjusted for forward looking estimates.

- At every reporting date, the historical observed default rates are updated to reflect current and forecast credit conditions.

Company M estimates the following provision matrix (based on aging) at 31 December 2014:

	Expected default rate	Gross carrying amount	Credit loss allowance (Expected default rate * Gross carrying amount)
Not past due	0.3%	$15 million	$45,000
1-30 days past due	1.6%	$7.5 million	$120,000
31-60 days past due	3.6%	$4 million	$144,000
61-90 days past due	6.6%	$2.5 million	$165,000
More than 90 days past due	10.6%	$1 million	$106,000
		$30 million	**$580,000**

For the $15 million trade receivables that are not past due, Company M recognises a provision of $45,000 which it would not recognise under the current AASB 139 impairment model.

At 31 December 2015, Company M revises its forward looking estimates and the general economic conditions are deemed to be less favourable than previously thought. Company M has a portfolio of trade receivables of $34 million in 2015.

	Expected default rate	Gross carrying amount	Credit loss allowance (Expected default rate * gross carrying amount)
Not past due	0.5%	$16 million	$80,000
1-30 days past due	1.8%	$8 million	$144,000
31-60 days past due	3.8%	$5 million	$190,000
61-90 days past due	7%	$3.5 million	$245,000
More than 90 days past due	11%	$1.5 million	$165,000
		$34 million	**$824,000**

The credit loss allowance has increased by $244,000 to $824,000 as at 31 December 2015. The journal entry at 31 December 2015 would be:

	DR	CR
DR Expected credit losses	$244,000	
CR Credit loss allowance		$244,000

For entities with only trade receivables on their balance sheet, it is important to note that they should not only rely on historical loss rates, but should also adjust historical loss rates to reflect current and forecast credit conditions. Entities may also want to consider grouping receivables based on attributes other than debtors' days to improve the accuracy of estimating expected credit losses (e.g. geographical region, industry, customer rating etc.).

Implications for leasing companies and corporations with long term receivables

For long term trade receivables and lease receivables, entities have a choice to either apply the 'full' three stage model or the 'simplified' model.

Applying the 'simplified' model alleviates some of the operational challenges associated with the 'full' model e.g. assessing whether there has been a significant increase in credit risk. However, applying the 'simplified' model will most likely lead to a higher provision than the 'full' model because:

- Under the 'simplified' model, all expected credit losses would be provided for at the first reporting date
- Under the 'full' model, only a portion (12 months) of credit losses are provided for, (life time expected credit losses are not recognised until there has been a significant increase in credit risk of the receivable under the 'full' model).

Implications for intercompany loans

Unfortunately, the standard does not provide any practical expedients for intercompany loans. This means that in an entity's standalone accounts, expected credit losses (and the related disclosures) would have to be provided based on the 'full' three stage model.

Impairment Transition Group

To provide stakeholders a forum to discuss implementation issues arising from the new impairment model, the IASB has established a Transition Resource Group for Impairment of Financial Instruments (ITG).

One of the issues discussed at the first face-to-face ITG meeting held in London in April 2015 was whether the new impairment model would also apply to:

- Lease commitments – i.e. commitment by a lessor to commence a finance lease at a future date, and
- Store credit cards/accounts – i.e. commitment by a retailer through the issue of a store account to give a customer credit when the customer buys goods or services from the retailer in future.

The views at the ITG discussions were that the new impairment requirement would not apply to the above items because they do not meet the definition of a financial instrument. The new impairment model would apply from:

- The commencement of the lease when a lease receivable is recognised, and
- When the goods or services are sold and a trade receivable is recognised for store accounts/store credit cards.

Wayne Basford of BDO is a member of the ITG. If you would like to discuss any implementation issues on the new impairment model, please contact Wayne or Judith Leung directly. Judith was formerly a staff member at the IASB and was involved in the initial phase of the project at the IASB.