Changes to accounting for Financial Instruments – Impairment of Receivables

Overview

The impairment model under AASB 139 Financial Instruments: Recognition and Measurement was based on recognising an 'incurred loss' when something happened after the financial asset was initially recognised.
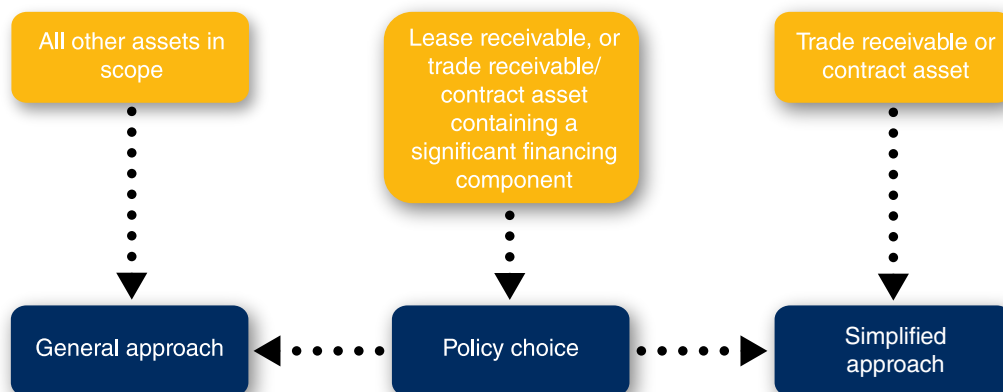
The new AASB 9 Financial Instruments, which is effective for financial reporting periods beginning on or after 1 January 2018, sets out new requirements for impairment of financial assets, including receivables using an expected credit loss model.

As a result, impairment losses are recognised at an earlier stage than they have been in the past and expected credit losses are required to be measured at each reporting date.

There is significant judgement involved in determining whether there has been a significant increase in credit risk for receivables and determining impairment in accordance with the expected loss model.

Impairment of financial assets

AASB 9 sets out two models for measuring impairment losses and loss allowances (commonly known as a provision for doubtful debts or provision for impairment) on financial assets at amortised cost and those recognised at fair value through other comprehensive income (OCI) with recycling. These are the general model and the simplified model. The diagram below shows which model to use based on the type of a financial asset:

All other assets in scope	Lease receivable, or trade receivable/ contract asset containing a significant financing component	Trade receivable or contract asset
↓	↓	↓
General approach	← · · · → Policy choice · · · →	Simplified approach

Simplified approach - trade receivables

The standard includes a simplified approach, as applying the general approach to trade receivables and contract assets that do not have a significant financial component would be onerous. The simplification stands in recognising lifetime expected losses on initial recognition. As trade receivables are usually due within 12 months, this would result in much the same answer.

There are many ways to calculate a loss allowance. The key is as follows:

Expected credit loss = carrying amount x probability of default x loss given default.

Probability of default

Determining the probability of default requires high levels of estimation and judgement. In practice, it is expected that historical information will be used as a starting point. Events that caused impairment losses in the past should be reviewed and considered as to whether these events are likely to occur in the future. Further consideration should be given to what other possible events may occur in the future and adjust the historical loss rates accordingly.

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

Unlike the existing standard, the loss allowance is not required to be calculated for each debtor individually. Rather, debtors can, and should be, grouped and a probability of default applied to the group of debtors. You should analyse the population of debtors to identify how best to stratify the population and apply a matrix to measure the loss allowance.

Loss given default

When determining the loss given default, the cash flows that will be received in the event of default should include the cash flows expected from collateral. If you have collateral or other forms of security, you need to consider any costs incurred in collecting the collateral and the time value of money.

In addition, costs incurred when collecting overdue amounts and losses associated with the time value of money are also losses in the context of determining the expected credit loss. These should be factored into the loss given default.

Provision matrix

Many entities determine the provision for doubtful debts based on their ageing. This approach could be used under the new standard in developing a provision matrix. The difference to current practice is adjustments to historical discount rates for forward-looking information and applying a probability of default to current debtors. A separate provision matrix should be applied to appropriate groupings of receivables based on shared credit risk characteristics.

Summary

Step 1
Determine the appropriate groupings of receivables into categories of shared credit risk characteristics.

Step 2
Determine the period over which historical loss rates are obtained to develop estimates of expected future loss rates.

Step 3
Determine the historical loss rates.

Step 4
Consider forward looking factors and adjust historical loss rates to reflect relevant future economic conditions.

Step 5
Calculate the expected credit losses.

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