IFRS 9 - Expected Credit Loss

Consideration for accounts receivable and contract assets

2019
Overview

Expected Credit Loss (ECL) Model

- Financial assets that are measured at amortized cost:
  - Accounts receivable, loans, debt securities, bank balances and deposits, etc.
- Financial assets that are debt instruments measured at fair value through other comprehensive income
- Loan commitments that are not measured at fair value through profit or loss under IFRS 9
- Financial guarantee contracts that are not measured at fair value through profit or loss under IFRS 9
- Lease receivables
- Contract assets

Scope

- Credit loss: 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).
- The new requirements are designed to result in earlier recognition of more credit losses (as compared to the recognition of individual incurred losses under IAS 39).
- The measurement of ECLs reflects a probability-weighted outcome, the time value of money and the best available forward-looking information.
- The need to incorporate forward-looking information means that application of the standard will require considerable judgement as to how changes in macroeconomic factors will affect ECLs.
- The simplified approach does not require an entity to track the changes in credit risk, but, instead, requires the entity to recognize a loss allowance based on lifetime ECLs at each reporting date, right from origination.

Key changes from the IAS 39 impairment requirements

- The scope of the impairment requirements is now much broader
- 12-month and lifetime ECL
- More forward-looking
- General approach vs simplified approach
Effective date and transition


Modified retrospective approach
► Cumulative-effect adjustment as of the beginning of the first reporting period in which the guidance is effective
► Prior periods will not be comparative

*Except for the insurance companies which meet specific exemption requirements
Life cycle of a revenue contract
Consideration of collectability from inception to resolution

IFRS 15

1. Identify the contract with a customer
2. Identify the performance obligations
3. Determine transaction price
4. Allocate the transaction price to performance obligations
5. Recognize revenue when (or as) performance obligations are satisfied

IFRS 9

Collect or write off receivable

IFRS 15 applies to a contract that meets specified criteria, one of which is that it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

The transaction price is adjusted for variable consideration, including implicit price concessions resulting from a customer’s expectations of price reduction based on the entity’s customary business practices, published policies or specific statements made by the entity.

► An entity is required to apply the simplified approach for trade receivables or contract assets that result from transactions within the scope of IFRS 15 and that do not contain a significant financing component, or when the entity applies the practical expedient for contracts that have a maturity of one year or less, in accordance with IFRS 15.

► An entity has a policy choice to apply either the simplified approach or the general approach for all trade receivables or contract assets that result from transactions within the scope of IFRS 15 and that contain a significant financing component in accordance with IFRS 15.
## Methodology considerations

<table>
<thead>
<tr>
<th>Risk of loss</th>
<th>Forward-looking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use historical loss experience as starting point</td>
<td>The need to incorporate forward-looking information means that application of the standard will require considerable judgement as to how changes in macroeconomic factors will affect ECLs.</td>
</tr>
<tr>
<td>No expectation of loss likely not appropriate; anticipate losses on receivables that are past due as well as those that have not yet shown indicators of impairment (i.e., current with respect to payment terms)</td>
<td>Determine what factors or economic conditions drive loss experience</td>
</tr>
<tr>
<td>Group receivables based on risk characteristics (e.g., customer credit score, aging)</td>
<td></td>
</tr>
</tbody>
</table>

### Evaluating relevant risk factors associated with assets in scope is a critical step in assessing the extent of implementation efforts required.

<table>
<thead>
<tr>
<th>Determining stages and life</th>
<th>Data and modeling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determine whether the credit risk has significant increases (applicable under general approach)</td>
<td>Availability of historical loss information</td>
</tr>
<tr>
<td>Understand key contract terms that may affect life</td>
<td>Internal controls: data retention and data integrity</td>
</tr>
<tr>
<td>Evaluate impairment on contract assets that will transition from a contract asset to a receivable</td>
<td>May need to model losses based on expectation of forecasted conditions</td>
</tr>
</tbody>
</table>
For the purpose of determining significant increases in credit risk and recognizing a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis.

- Entities can base pooling of accounts receivable and contract assets on any one or a combination of characteristics.
- Examples of shared credit risk characteristics given in the standard include, but are not limited to: Instrument type, credit risk rating, collateral type, date of initial recognition, remaining term to maturity, industry, geographical location of the borrower, and the value of collateral relative to the asset.

Any instruments assessed collectively must possess shared credit risk characteristics. It is not permitted to aggregate exposures that have different risks.
Company A is a producer of industrial equipment and sells to both wholesalers and retailers. It requires payment within 90 days and provides no other financing.

Company A notes that its historical credit loss experience correlates with aging. Company A also notes that historical credit losses of wholesalers differ from those of retailers.

Based on this historical experience, Company A pools the trade receivables first by customer type, then by aging. Company A pools its outstanding trade receivables as of 31 December 20X7 into the following pools (in USD’000):

<table>
<thead>
<tr>
<th>Customer type</th>
<th>Within 1 year</th>
<th>1-2 years</th>
<th>2-3 years</th>
<th>More than 3 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesalers</td>
<td>300,000</td>
<td>74,000</td>
<td>10,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Retailers</td>
<td>400,000</td>
<td>20,000</td>
<td>8,000</td>
<td>55,500</td>
</tr>
</tbody>
</table>
Developing the loss estimate

The estimate will require more judgment and needs to be supported.

- **Starting point for estimate**
  - Historical loss information

- **Historical loss information**
  - Asset-specific characteristics
  - Current conditions
  - Reasonable and supportable forecast

- **Entities need to consider data integrity and availability.**

- **Shorter-term assets may not require complex modeling to incorporate a forecast. Forecasted economic conditions may not have a significant effect on the credit loss estimate for these assets.**

- **Adjustments to historical loss information**
  - Entities should consider consistency with other forecasts used (e.g., goodwill impairment).
Method using an aging schedule
Illustration

Assume the same facts as in the previous example. The account receivables of retailers have no significant credit risk concentration, so Company A cannot and has no need to trace the credit risk of each account receivable. Based on historical experience, Company A notes aging is a key characteristic of credit risk of the group of account receivables of retailers, so it builds the provision matrix by aging. In addition, Company A believes a higher unemployment rate will drive a higher loss rate over the life of the receivables. To adjust the historical loss rates to reflect the effects of the differences in current conditions and reasonable and supportable forecasts, Company A estimates that the loss rate will increase by 5% in each aging bucket, based on its past experience when there were similar increases in unemployment.

At the reporting date, Company A develops the following aging schedule to estimate expected credit losses related to its retailer customers:

Step 1: Data summary and analysis
Aging of account receivables of retailers at the end of each of last 4 years:

<table>
<thead>
<tr>
<th></th>
<th>20X4</th>
<th>20X5</th>
<th>20X6</th>
<th>20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aging</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Within 1 year</td>
<td>300,000</td>
<td>200,000</td>
<td>250,000</td>
<td>400,000</td>
</tr>
<tr>
<td>1-2 years</td>
<td>70,000</td>
<td>30,000</td>
<td>17,000</td>
<td>20,000</td>
</tr>
<tr>
<td>2-3 years</td>
<td>13,000</td>
<td>28,000</td>
<td>12,000</td>
<td>8,000</td>
</tr>
<tr>
<td>More than 3 years</td>
<td>10,000</td>
<td>21,700</td>
<td>45,000</td>
<td>55,500</td>
</tr>
<tr>
<td>Includes: not received in the current year and has been more than 3 years since last year</td>
<td>-</td>
<td>10,000</td>
<td>21,700</td>
<td>45,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>393,000</strong></td>
<td><strong>279,700</strong></td>
<td><strong>324,000</strong></td>
<td><strong>483,500</strong></td>
</tr>
</tbody>
</table>
Method using an aging schedule
Illustration (continued)

Step 2: Migration and the calculation of historical loss rate
Company A calculate the historical loss rate as below:

<table>
<thead>
<tr>
<th>Aging</th>
<th>Migration from 20X4 to 20X5</th>
<th>Migration from 20X5 to 20X6</th>
<th>Migration from 20X6 to 20X7</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 1 year</td>
<td>A 10.00%*</td>
<td>8.50%</td>
<td>8.00%</td>
<td>8.83%</td>
</tr>
<tr>
<td>1-2 years</td>
<td>B 40.00%</td>
<td>40.00%</td>
<td>47.06%</td>
<td>42.35%</td>
</tr>
<tr>
<td>2-3 years</td>
<td>C 90.00%</td>
<td>83.21%</td>
<td>87.50%</td>
<td>86.90%</td>
</tr>
<tr>
<td>More than 3 years</td>
<td>D 100.00%</td>
<td>100.00%</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

Migration rate refers to the percentage of the balance moving to the next aging period in each aging schedule. For example: at the end of 20X4, the balance of account receivables with aging of within 1 year is USD300 million, then the balance of which moved to the next aging period in 20X5 amounting to USD30 million, so the migration rate is 10% (30,000/300,000=10%).

Historical loss rate

<table>
<thead>
<tr>
<th>Aging</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 1 year</td>
<td>3.25%</td>
</tr>
<tr>
<td>1-2 years</td>
<td>36.81%</td>
</tr>
<tr>
<td>2-3 years</td>
<td>86.90%</td>
</tr>
<tr>
<td>More than 3 years</td>
<td>100.00%</td>
</tr>
</tbody>
</table>
Company A believes a higher unemployment rate will drive a higher loss rate over the life of the receivables. To adjust the historical loss rates to reflect the effects of the differences in current conditions and reasonable and supportable forecasts, Company A estimates that the loss rate will increase by 5% in each aging bucket, based on its past experience when there were similar increases in unemployment.

<table>
<thead>
<tr>
<th>Aging</th>
<th>Balance as at the end of 20X7</th>
<th>Expected credit loss rate (historical loss rate* (1+5%))</th>
<th>ECL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 1 year</td>
<td>400,000</td>
<td>3.41%</td>
<td>13,655</td>
</tr>
<tr>
<td>1-2 years</td>
<td>20,000</td>
<td>38.65%</td>
<td>7,729</td>
</tr>
<tr>
<td>2-3 years</td>
<td>8,000</td>
<td>91.25%</td>
<td>7,300</td>
</tr>
<tr>
<td>More than 3 years</td>
<td>55,500</td>
<td>100.00%</td>
<td>55,500</td>
</tr>
<tr>
<td>Total</td>
<td>483,500</td>
<td></td>
<td>84,184</td>
</tr>
</tbody>
</table>
## New disclosure requirements

### Credit risk management practices
How to determine whether the credit risk has increased significantly since initial recognition; definition of default; how the instruments were grouped if ECLs were measured on a collective basis; how to determine that financial assets are credit-impaired; write-off policy; how the requirements for the modification of contractual cash flows of financial instruments have been applied; the basis of inputs and assumptions and the estimation techniques; forward-looking information, etc.

### Quantitative information about amounts arising from expected credit losses
The changes in the loss allowance and reasons for those changes by presenting a reconciliation of the opening balance to the closing balance. The effect of modifications of contractual cash flows as well as the effect of such modifications on the measurement of ECLs; the effect of collateral and other credit enhancements on the amounts arising from ECLs.

### Credit risk exposure
By ‘credit risk rating grades’, the gross carrying amount of financial assets; a concentration of credit risk exists; for financial instruments within the scope of IFRS 7 to which the impairment requirements in IFRS 9 are not applied, disclosure should be given by class of instrument of the amount that best represents the entity’s maximum exposure to credit risk at the reporting date.

### Other useful information
The information of collateral and other credit enhancements obtained.
Implementation lessons learned

1. Don’t underestimate the extent of system, process, controls and governance changes – especially within finance.

2. Different stage of credit risk may result in significantly different ECL.

3. Entities need to consider data integrity and availability.

4. Consider how to incorporate forward-looking information early in the implementation process.

5. Consider the new disclosure requirements when evaluating new data and systems that will be needed.
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