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CL 02 – Financial Reporting and Governance

Corporate Level

(Financial Instruments – P 02)

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6. IMPAIRMENT

6.1 Scope

The following financial instruments are included within the scope of the impairment requirements in SLFRS 9:

- Debt instruments measured at amortised cost, e.g.
  - Trade receivables;
  - Loans receivable from related parties or key management personnel;
  - Deferred consideration receivable; and
  - Intercompany loans in separate financial statements.
- Debt instruments that are measured at fair value through other comprehensive income (FVOCI), e.g. long dated government or corporate bond;
- Issued loan commitments (except those measured at FVTPL);
- Issued financial guarantee contracts (except those measured at FVTPL);
- Lease receivables within the scope of SLFRS 16 Leases;
- Contract assets within the scope of SLFRS 15 Revenue from Contracts with Customers;
- Receivables arising from transactions within the scope of SLFRS 15.

SLFRS 9 applies an 'expected loss' model to impairment, in other words, an impairment, or credit losses, are recognised **when expected** rather than when incurred.

6.2 Key Definitions

Credit loss	The difference between all contractual cashflows that are due to an entity… and all the cash flows that an entity expects to receive, discounted.
Expected credit losses	The weighted average of credit losses with the respective risks of a default occurring as the weights.
Lifetime expected credit losses	The expected credit losses that result from all possible default events over the expected life of a financial instrument
Loss allowance	The allowance for expected credit losses on financial assets.

Past due	A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.

6.3 Approach to Impairment

SLFRS 9 provides 3 approaches to impairment:

(1) A general approach
(2) A simplified approach relevant to trade receivables.

6.4 The General Approach (Para 5.5.1)

On initial recognition of a financial asset and at each subsequent reporting date, a loss allowance for expected credit loss must be recognised. At initial recognition of a financial asset, a loss allowance equal to 12-month expected credit losses must be recognised.

12-month expected credit losses are defined as 'the portion of lifetime expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date' (SIFRS 9: Appendix A).

They are calculated by multiplying the probability of default in the next 12 months by the present value of the lifetime expected credit losses that would result from the default. At each subsequent reporting date, the loss allowance required depends on whether there has been a significant increase in credit risk of that financial instrument since initial recognition.

The ECL Model can be summarized as follows.

	Stage 1	Stage 2	Stage 3
	Credit risk has not increased significantly since initial recognition	Credit risk has increased significantly since initial recognition	There is objective evidence of impairment at the reporting date. (Credit Impaired)
Recognition of Impairment	**12-month** expected credit losses	**Lifetime** expected credit losses	
Recognition of Interest Income	Effective interest on the **Gross** carrying amount of the asset (**Before** deducting ECL)		Effective interest on the **Net** carrying amount of the asset (**After** deducting ECL)

However as a practical expedient, a **simplified model applies for**:

- Trade receivables or contract assets without a significant financing component (or when the IFRS 15 Paragraph 63 practical expedient is applied for the effects of a significant financing component to those with maturities of less than 12 months); and
- Other long-term trade receivables or contract assets with a significant financing component and lease receivables if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses.

In estimating ECLs, **entities must consider a range of possible outcomes and not the 'most likely' outcome**. The standard requires that at a **minimum**, entities must consider the probability that:

- A credit loss occurs; and
- No credit loss occurs.

6.4.1 Recognition of impairment – 12-month expected credit losses

12-month ECLs are calculated by multiplying the probability of a default occurring in the next 12 months by the total (lifetime) ECLs that would result from that default, regardless of when those losses occur. Therefore, **12-month expected credit losses represent a financial asset's lifetime expected credit losses that are expected to arise from default events that are possible within the 12-month period** following origination of an asset, or from each reporting date for those assets in **Stage 1**.

The distinction between 12-month expected credit losses to be calculated in accordance with SLFRS 9 and the cash shortfalls that are anticipated to arise over the next 12 months is important.

- As an example, the death of a credit card borrower does lead, in a number of cases, to the outstanding balance becoming impaired. Linking this to the accounting requirements, the SLFRS 9 model therefore requires the prediction on initial recognition (and at each reporting date) of the likelihood of the borrower dying in the next 12 months and hence triggering an impairment event. Given the very large number of balances, it is likely that this would be calculated on a portfolio basis and not for each individual balance.

6.4.2 Recognition of impairment – Lifetime expected credit losses

Lifetime expected credit losses are the present value of expected credit losses that arise if a borrower defaults on its obligation at any point throughout the term of a lender's financial asset. This requires an entity to **consider all possible default events during the term of the financial asset in the analysis**. Lifetime expected credit losses are calculated based on a weighted average of the expected

credit losses, with the weightings being based on the respective probabilities of default.

6.5 Determining Significant Increases in Credit Risk (SICR) (Para 5.5.9)

The transition from recognising 12-month expected credit losses (i.e. Stage 1) to lifetime expected credit losses (i.e. Stage 2) in SLFRS 9 is based on the notion of a **significant increase in credit risk (SICR)** over the remaining life of the instrument in comparison with the credit risk on initial recognition. The **focus is on the changes in the risk of a default**, and not the changes in the amount of expected credit losses.

- *For example, for highly collateralised financial assets such as real estate backed loans, when a borrower is expected to be affected by the downturn in its local economy with a consequent increase in credit risk, that loan would move to Stage 2, even though the actual loss suffered may be small because the lender can recover most of the amount due by selling the collateral.*

At each reporting date, an entity **shall assess** whether the credit risk on a financial instrument has increased significantly since initial recognition. There is a **rebuttable presumption** that the credit risk has increased significantly when contractual payments are more than 30 days past due.

A significant increase in credit risk (moving from Stage 1 to Stage 2) **can include**:

- Changes in general economic and/or market conditions (e.g. expected increase in unemployment rates, interest rates);
- Significant changes in the operating results or financial position of the borrower;
- Changes in the amount of financial support available to an entity (e.g. from its parent);
- Expected or potential breaches of covenants;
- Expected delay in payment (Note: Actual payment delay may not arise until after there has been a significant increase in credit risk).
- An actual or expected downgrade in the borrower's credit rating

The movement from stage 1 to stage 2 is not irreversible; where credit losses have previously been measured at a lifetime amount, at a subsequent reporting date they are measured at a 12-month amount if a significant increase in credit risk is no longer evident.

6.6 Objective evidence of impairment

A financial asset **moves to stage 3** of the model when there is objective evidence of impairment at the reporting date. SLFRS 9 provides examples of evidence of impairment including the following:

(a) Significant financial difficulty of the issuer
(b) A breach of contract, such as a default in interest or principal payments
(c) The lender granting a concession to the borrower that the lender would not otherwise consider, for reasons relating to the borrower's financial difficulty
(d) It becomes probable that the borrower will enter bankruptcy
(e) The disappearance of an active market for that financial asset because of financial difficulties
(f) The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses

It is not always possible to single out one particular event; rather, several events may combine to cause an asset to become credit-impaired.

6.7 Measurement of expected credit losses

An entity shall measure expected credit losses of a financial instrument in a way that reflects:

(a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes *(Expected credit losses should not be a best or worst-case scenario, but should reflect the possibility that a credit loss will occur, and the possibility that it will not).;*
(b) the time value of money; and
(c) 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.

6.8 Calculation of expected credit losses

Present value of principal and interest cash flows that are contractually due to an entity	XXX
(-) Present value of cash flows an entity expects to receive (After considering probability)	(XXX)
Expected Credit Loss	**XXX**

6.9 Treatment for expected credit losses in financial statements

Type of financial asset	Treatment of credit loss
Investments in debt instruments measured at **amortised cost** (AC)	• Recognised in profit or loss • Credit losses held in a separate allowance account offset against the carrying amount of the asset • Carrying amount = Financial asset – allowance for credit losses
Investments in debt instruments measured at fair value through other comprehensive income (**FVOCI**)	• Portion of the fall in fair value relating to credit losses recognised in profit or loss • Remainder recognised in other comprehensive income • No allowance account necessary because already carried at fair value (which is automatically reduced for any fall in value, including credit losses)

Question 15 – ECL General Approach

Tae Ltd advanced an interest-bearing loan to a supplier on 1 January 2015. The following information relates to this loan at 1 January and 31 December 2015:

	01.01.2015 (Rs.)	31.12.2015 (Rs.)
Present value of contractual cash flows	8,000,000	7,650,000
Present value of expected cash flows and associated probability of default within 12 months	8,000,000 – 95% 7,750,000 – 5%	7,650,000 – 85% 5,500,000 – 8% 1,000,000 – 7%

Required: What is the impairment loss at each date, assuming that credit risk has not increased significantly since initial recognition?

Question 16 – ECL General Approach

On 1 January 2014 Pedro Ltd acquired an investment in Rs. 60 million 8% loan stock. The investment is measured at amortised cost. At 1 January 2014 there is a 4% probability that the borrower will default on the loan during 2014 resulting in a 100% loss.

At 31 December 2014 there is 1% probability that the borrower will default on the loan before 31 December 2015 resulting in a 100% loss. At 31 December 2015 the borrower is expected to breach its covenants as a result of cash flow problems. There is a 45% probability of the loan defaulting over the remainder of its term.

At 31 December 2016 the borrower breached its covenants and there is a 75% probability of default over the remainder of the loan term.

Required: What impairment allowance and interest revenue are recognised at initial recognition and in each of the years ended 31 December 2014, 2015 and 2016?

Question 17 – ECL General Approach – FVOCI

An entity purchases a debt instrument for $1,000 on 1 January 2021. The interest rate on the bond is the same as the effective rate. After accounting for interest for the year to 31 December 2021, the carrying amount of the bond is still $1,000.

At the reporting date of 31 December 2021, the fair value of the instrument has fallen to $950. There has not been a significant increase in credit risk since inception so expected credit losses should be measured at 12-month expected credit losses. This is deemed to amount to $30.

Required: Explain how the revaluation and impairment of the financial asset should be accounted for.

6.10 The Simplified Approach (Para 5.5.15)

A simplified approach is permitted for trade receivables, contract assets and lease receivables. For trade receivables or contract assets that do not have a significant SLFRS 15 financing element, the loss allowance is measured at the lifetime expected credit losses, from initial recognition.

The new impairment model allows entities to calculate ECLs on trade receivables using a **provision matrix**. In practice, many entities already 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 need to update their historical provision rates with current and forward looking estimates. A similar approach might be followed for contract assets.

Question 18 – ECL Simplified Approach

Company M has trade receivables of Rs. 30 million at 31 December 2014. The customer base consists of a large number of small clients. In order 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 and forward-looking estimates are updated. Company M estimates the following provision matrix at 31 December 2014:

	Expected Default Rate	Gross Carrying Amount (Rs.)
Current	0.3%	15,000,000
1-30 days past due	1.6%	7,500,000
31-60 days past due	3.6%	4,000,000
61-90 days past due	6.6%	2,500,000
More than 90 days past due	10.6%	1,000,000

One year later, at 31 December 2015, Company M revises its forward looking estimates, which incorporate a deterioration in general economic conditions. Company M has a portfolio of trade receivables of Rs. 34 million in 2015.

	Expected Default Rate	Gross Carrying Amount (Rs.)
Current	0.5%	16,000,000
1-30 days past due	1.8%	8,000,000
31-60 days past due	3.8%	5,000,000
61-90 days past due	7.0%	3,500,000
More than 90 days past due	11.0%	1,500,000

Required: Explain how the loss allowance need to be recognized at each relevant date.

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7. DERIVATIVES

A derivative is a financial instrument that **derives its value from the price or rate of an underlying item**. Embedded derivatives may require separation from their host contract for accounting purposes.

A derivative is a financial instrument:

- Whose value changes in response to the change in price of an underlying security, commodity, currency, index or other financial instrument
- Where the initial net investment is zero or very small
- That is settled at a future date

A derivative is a financial instrument that derives its value from the price or rate of an underlying item. Common examples of derivatives include:

(a) Forward contracts: agreements to buy or sell an asset at a fixed price at a fixed future date
(b) Futures contracts: similar to forward contracts except that contracts are standardised and traded on an exchange
(c) Options: rights (but not obligations) for the option holder to exercise at a pre-determined price; the option writer loses out if the option is exercised
(d) Swaps: agreements to swap one set of cash flows for another (normally interest rate or currency swaps).

Derivatives may be a financial asset or a financial liability, depending on the movement in the underlying variable.

For example, if a company entered into a forward contract to sell coffee at a specified future date for Rs. 160 per pound, then:

- If the market price of coffee increases to Rs. 190 per pound, the contract is a financial liability, ie the company will be exchanging assets under unfavourable conditions.
- If the market price of coffee falls to Rs. 140 per pound, the contract is a financial asset, ie the company will be exchanging assets under favourable conditions. Long-term derivatives may fluctuate between an asset and a liability position.

Regardless of whether a derivative is a financial asset or liability, it is classified as fair value through profit or loss and the usual accounting rules apply:

(1) The derivative is initially measured at its fair value – usually nil.

(2) At subsequent reporting dates, it is measured at fair value with changes recognised in profit or loss.

Question 19 – Derivatives

On 1 October 2013, Plantation Products PLC commissioned a European company to design and build a large item of machinery for delivery at the end of March 2014. Payment of €5m would be due on this date. In order to reduce exposure to fluctuations in the exchange rate, Plantation Products PLC also entered into a forward contract on 1 October 2013 to buy €5m on 31 March 2014 for a fixed amount of Rs. 875m.

The contract has an initial fair value of zero. At 31 December 2013, the euro has appreciated and the value of €5m is Rs. 881m.

Required: Demonstrate how the forward contract is accounted for at 1 October 20X3 and 31 December 2013.

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