IFRS 9 Financial Instruments Impairment of Trade Receivables

July 2019

Introduction

In July 2014, the International Accounting Standards Board (IASB) completed Phase 2 of its financial instruments project related to impairment and, as such, published the final version of *IFRS 9 Financial Instruments.* IFRS 9 replaces IAS 39 *Financial Instruments: Recognition and Measurement* and is effective for annual periods beginning on or after January 1, 2018. Earlier application is permitted.

IFRS 9 uses an expected credit loss (ECL) model which replaces the current incurred loss model under IAS 39. The IFRS 9 impairment requirements aim to address concerns raised during the financial crisis relating to the current IAS 39 incurred loss impairment model which delays the recognition of impairment until there is objective evidence of impairment. IFRS 9 provides a simplified impairment approach for trade receivables, contract assets and lease receivables, and investments with low credit risk which will apply to most entities.

This guide highlights the objective of the impairment methodology and the key differences between the IAS 39 and IFRS 9 impairment models. It also provides an overview of the requirements and illustrative examples to assist in the application of the new IFRS 9 ECL model for trade receivables.

Key Differences Between IAS 39 and IFRS 9 Impairment Models

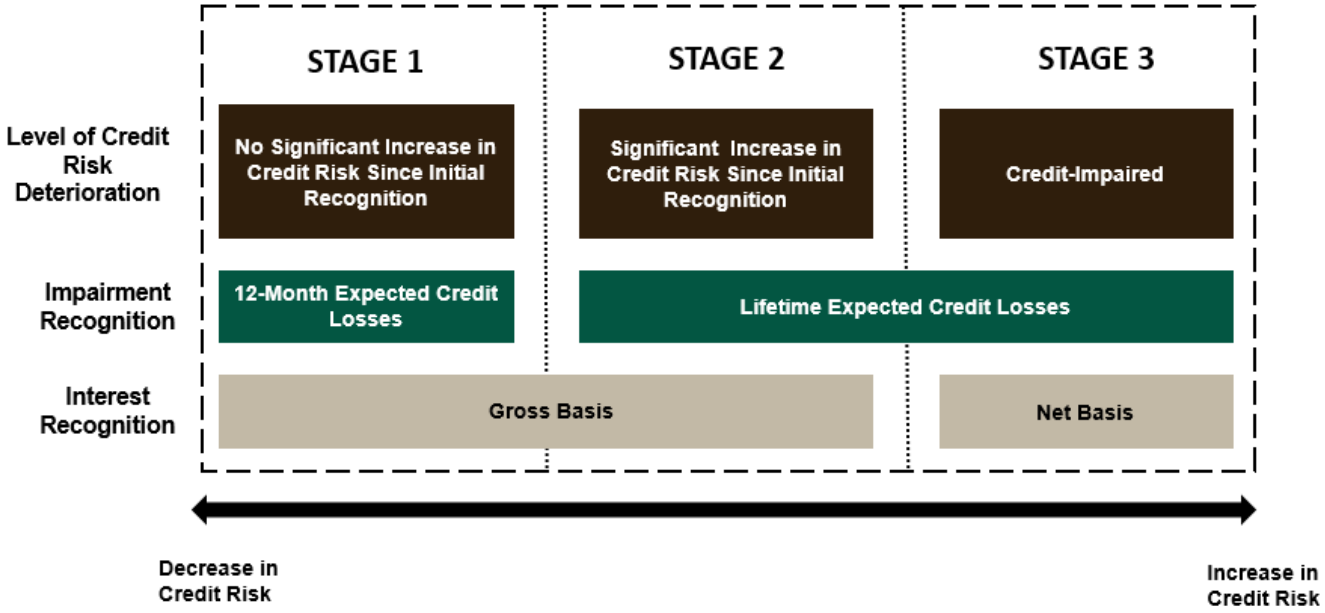
The impairment requirements under IFRS 9 are significantly different from those under IAS 39. The following table highlights the key differences between the two standards:

IFRS 9 Expected Credit Loss Model	IAS 39 Incurred Loss Model
ECLs are recognized at each reporting period, even if no actual loss events have taken place.	▪ Delays the recognition of credit losses until there is objective evidence of impairment.
▪ In addition to past events and current conditions, reasonable and supportable forward-looking information that is available without undue cost or effort is considered in determining impairment.	▪ Only past events and current conditions are considered when determining the amount of impairment (i.e., the effects of future credit loss events cannot be considered, even when they are expected).

General Impairment Approach

The following diagram provides a high-level overview of the general IFRS 9 impairment approach:

Diagram 1



Note! There is a general approach to impairment (presented in the diagram above and discussed in detail in the IFRS 9 impairment guide – An Overview of the Impairment Requirements of IFRS 9 *Financial Instruments* issued in February 2017 available on The Loop).

There are two exceptions to the general impairment approach:

1. Simplified Approach for Purchased or Originated Credit-Impaired Financial Assets
2. Simplified Approach for Trade and Lease Receivables and Contract Assets

Note! The first exception relating to purchased or originated credit-impaired financial assets is not discussed in this guide. See IFRS 9 impairment guide – An Overview of the Impairment Requirements of IFRS 9 *Financial Instruments* issued in February 2017 available on The Loop for guidance on how this exception applies.

Simplified Impairment Approach for Trade Receivables

One of the exceptions to the general impairment approach is a simplified approach that may apply to certain trade receivables, contract assets and lease receivables. Depending on the type of item, the simplified approach is either mandatory or the entity has an accounting policy choice. Two questions determine the applicability of the simplified approach:

Exception 2a: *Is the instrument a trade receivable/contract asset without a significant financing component (see IFRS 15) or does the entity apply the IFRS 15 practical expedient for contracts finalized within one year?*	***Exception 2b:*** *Is the instrument a lease receivable (see IAS 17) or trade receivable/contract asset with a significant financing component and the entity elected to always recognize lifetime ECLs?*
If yes, an allowance for lifetime ECLs is always recognized for: ▪ Receivables and contract assets without a significant financing component; or ▪ When the entity applies the practical expedient (for contracts that are one year or less) in accordance with IFRS 15.	If yes, the entity elected to recognize an allowance for lifetime ECLs for: ▪ Trade receivables and contract assets with a significant financing component; and ▪ Lease receivables. If no election was made, the entity continues to apply the general impairment approach.

Note! Under the simplified approach, lifetime ECLs are always recognized. Accordingly, the simplified approach eliminates the need for an entity to calculate the 12-month ECLs and the instrument can only fall in Stage 2 or 3. In addition, there is no need to evaluate whether the credit quality has deteriorated significantly since initial recognition to determine whether a change between Stage 1 and 2 took place.

a) How consistent should the policy election be applied? Can an entity apply it to some trade receivables but not others?

An entity may select its accounting policy choice for trade receivables, lease receivables and contract assets independently of each other. However, the policy must be applied consistently within each category. For example, an entity can apply the accounting policy for its trade receivables, and must do so for all trade receivables, but can choose not to apply the accounting policy for its lease receivables and contract assets.

b) Can an entity use other practical expedients to measure ECLs?

IFRS 9 allows the use of practical expedients in the measurement of ECLs so long as the measurement reflects:
- A range of unbiased and probability-weighted outcomes.
- The discounted present value of the ECLs.
- The consideration of historical events, current conditions and forecasts of future economic conditions if the information is available without undue cost or effort.

A common practical expedient applied to measure ECLs for trade receivables is the use of a provision matrix. A provision matrix could be as simple as assigning default rates to different time periods reflecting the aging of the trade receivables. In contrast, a provision matrix could be more multifaceted if the entity experiences significantly different loss patterns for different customer segments. In such situations, the trade receivables would be categorized based on relevant criteria

(e.g. geographical region, product type, customer rating, collateral or trade credit insurance and type of customer) with different default rates assigned to each grouping. Nevertheless, the provision matrix would be developed based on the entity's historical credit loss experience and adjusted for current conditions and future forecasts.

Significant Financing Component

Contracts with a significant financing component are those for which the agreed timing of payment provides the customer or the entity with a significant benefit of financing on the transfer of goods or services. In determining the transaction price in such situations, an entity is required to adjust the promised amount of consideration for the effects of the time value of money. A significant financing component may exist within a contract regardless of whether it is explicitly stated in the contract or implied by the agreed payment terms. However, if at contract inception, the entity anticipates that only a year or less will pass between when the entity transfers a promised good or service to a customer and when payment is received from the customer, as a practical expedient, an entity is not required to adjust the promised amount of consideration for the effects of a significant financing component.

Estimating ECL for Trade Receivables Using the Simplified Approach

As discussed above, a provision matrix is an approach used in estimating ECLs for trade receivables. A provision matrix is determined based on the entity's experience of its customers delinquency history which is then used in estimating the potential ECLs for trade receivables. In order the apply the provision matrix to estimate ECL for an entity's trade receivables, the listed steps need to be followed:

- Determine appropriate groupings of trade receivables balance,
- Determine the historical loss rate,
- Consider the impact of forward-looking information and probability-weighted outcomes, and;
- Calculate estimated ECL by group.

Determining appropriate groupings

In adopting the provision matrix approach, the entity needs to group its trade receivables based on similar attributes and similar historical loss rate pattern. Determining the basis for appropriate group of trade receivables into categories of similar characteristics could be based on geographical region, customer type, customer rating, trade credit insurance, product type, etc. Trade receivables within each category are then analyzed by days past due (e.g. current, 30-89 days, over 90 days, etc.) in order to determine historical losses based on those sub-categories.

Determining the historical loss rate

After determining the various category and sub-categories applicable within the entity's trade receivables balance, the next step to take is to determine the historical loss rate for each sub-category within each group identified (e.g. historical loss rate for trade receivables not past due, historical loss rate for 30-89 days, historical loss rate for over 90 days, etc.). IFRS 9 does not provide specific guidance on how to determine the historical loss rates. An average of 3-5 years historical loss rate data is considered reasonable to estimate an average historical loss rate.

Example: Historical loss rate

The 5-year historical trade receivables balance of a retail and wholesale trading company including its actual net loss written off for the retail customer within the 91 -180 days past due category are shown in the table below. The historical loss rate is determined by calculating what percentage of the trade receivable balance was written off.

Year	Trade Receivable 91-180 days past due ($)	Net Amount Written-off ($)	Historical Loss Rate (%)
1	$27,389	1,858	6.78%
2	23,899	1,488	6.23
3	46,709	1,124	2.41
4	35,484	2,548	7.18
5	45,968	5,549	12.07
	$35,890	**$2,513**	**7.00%**

Considering forward-looking information and probability weighting

The average historical rates determined are adjusted for current conditions and forward-looking information available to the entity without undue cost or efforts at each reporting date. This does not have to be statistically determined however, all judgements and assumptions need to be assessed for reasonability and properly documented. The entity needs to determine possible outcomes and where it has been determined that those scenarios are likely to occur, this need to be considered and adjusted for in the estimated historical loss rates calculated in the previous step. Examples of forward-looking information that can affect the default rate include unemployment rate, consumer price index, interest rates, gross domestic product, etc.

Example: possible scenarios

Management expects that due to declining market conditions expected loss rates for the 91-180 days past due receivables will increase.

Scenario 1: 80% chance that the loss rate will increase to 9.375%.
Scenario 2: 20% chance that the loss rate will remain at the historical rate of 7.000%.

	Expected Loss Rate (%)	Probability Weighting (%)	Probability Weighted Rate (%)
1	9.375%	80.00	7.50
2	7.000	20.00	1.40
		100.00%	**8.90%**

Estimating ECL

The ECL for each sub-category within each identified group is determined by multiplying the gross carrying amount of trade receivables in that sub-category by the adjusted historical loss rate determined for that sub-category. Where trade receivables are short-term in nature, no effect of discounting is considered. However, where there is a significant financing component, the entity needs to consider the effect of discounting in the ECL estimation process.

Examples of Determination of ECL

Determining ECL for Trade Receivables Using a Provision Matrix (no significant financing component)

The example below demonstrates the use of a provision matrix which is expected to be used frequently in practice.

Determining a Loss Allowance for Trade Receivables Using a Provision Matrix

This example illustrates the mechanics of the impairment calculation applicable to trade receivables when using a provision matrix. The situation is assessed under both the IAS 39 and IFRS 9 standards below.

A Ltd., a wholesale trading company, has trade receivables with a gross carrying amount of $1,000,000 at the end of 2018. Trade receivables balances are due within 30 days.

Analysis of the trade receivables showed the following:

- A Ltd. serves a wide customer base of small clients and groups its trade receivables based on common credit risk characteristics that are representative of the customers' ability to pay all amounts due according to the contractual terms.
- The simplified approach under IFRS 9 applies to these trade receivables because they do not have a significant financing component. The receivables are all short-term in nature and the effect of discounting is immaterial.
- One of A Ltd.'s customers, debtor Z, filed for bankruptcy proceedings during 2018. A Ltd.'s receivable from debtor Z amounts to $40,400 and A Ltd. expects to recover close to nil based on the limited information currently available regarding the value of the collateral held.
  Aging structure of the trade receivables is as follows (A Ltd. calculated historical loss rates for each past due category percentages):

Aging (Days Past Due)	Trade Receivables Balance ($)	Historical Loss Rate (%)
Not past due	$748,400	-%
1-30 days	104,600	0.22
31-90 days	55,200	4.30
91-180 days	26,400	7.00
181-365 days	15,000	14.00
365+ days	10,000	63.50
Debtor Z	40,400	n/a
Total	**$1,000,000**	**n/a**

Impairment IFRS 9:

The provision for credit losses on Debtor Z's receivable of $40,400 will not be any different under IFRS 9. This receivable is credit-impaired and full lifetime ECLs is simply 100% of this receivable.

Determining a Loss Allowance for Trade Receivables Using a Provision Matrix *(continued from previous page)*

A Ltd. has reasonably supportable information that indicates that economic conditions will deteriorate over the next year. Therefore, the historical loss rates were adjusted to reflect this forward-looking information. To determine the ECLs for the other receivables, A Ltd. uses a provision matrix. As previously discussed, the provision matrix uses historically observed default rates over the expected life of the trade receivables, adjusted for current conditions and forward-looking estimates. At every reporting date, A Ltd. reviews and adjusts its historically observed default rates based on current conditions and changes in the future forecasts.

Based on the expectation that the economic condition is expected to worsen, management has estimated that this will result in an increase in the potential default rate across the various receivable categories. Therefore, based on this, management as adjusted the historical loss rate upwards to reflect the forward-looking information. The total provision for ECLs under IFRS 9 would be as follows:

Aging (Days Past Due)	Trade Receivables Balance($)	Historical Loss Rates (%)	Historical Loss Rates Adjusted for Current Conditions and Forward-Looking Information (%)	Provision for ECLs ($ × %)
Not past due	$748,400	0.00%	0.50%	$3,742
1-30 days	104,600	0.22	0.80	837
31-90 days	55,200	4.30	5.60	3,091
91-180 days	26,400	7.00	8.90	2,350
181-365 days	15,000	14.00	20.30	3,045
365+ days	10,000	63.50	63.90	6,390
Debtor Z	40,400	n/a	100.00	40,400
Total	**$1,000,000**		**n/a**	**$59,855**

The calculations assume that the ECLs represented by the historical loss rates adjusted for forward-looking information will occur. Hence, there is an implied probability of 0% that no loss will occur. In addition, the receivables are short-term and hence discounting will result in no impact on the estimated ECL due to no significant financing impact component.

Determining a Loss Allowance for Trade Receivables Using a Provision Matrix (significant financing component)

The example below demonstrates the use of a provision matrix which is expected to be used frequently in practice.

Determining a Loss Allowance for Trade Receivables Using a Provision Matrix

This example illustrates the mechanics of the impairment calculation applicable to trade receivables when using a provision matrix. The situation is assessed under both the IAS 39 and IFRS 9 standards below.

A Ltd., a trading company, has trade receivables with a gross carrying amount of $1,000,000 at the end of 2018. Careful analysis of the trade receivables showed the following:

- A Ltd. serves a wide customer base of small clients and groups its trade receivables based on common credit risk characteristics that are representative of the customers' ability to pay all amounts due according to the contractual terms.
- The simplified approach under IFRS 9 applies to these trade receivables because they do have a significant financing component. The receivables are all due within 90 days and can be paid within 3.5 years and interest rate is charged to all customers at the rate of 3.50%.
- One of A Ltd.'s customers, Debtor Z, filed for bankruptcy proceedings during 2018. A Ltd.'s receivable from debtor Z amounts to $40,400 and A Ltd. expects to recover close to nil based on the limited information currently available regarding the value of the collateral held.
- Aging structure of the trade receivables is as follows (A Ltd. calculated historical loss rates for each past due to category percentages):

Aging (Days Past Due)	Trade Receivables Balance ($)	Average life of receivables	Historical Loss Rate (%)
Not past due	$748,400	3.5	-%
91-180 days	104,600	2.8	0.22
181-365 days	55,200	2.5	4.30
365-730 days	26,400	2.0	7.00
731-1095 days	15,000	1.9	14.00
1096+ days	10,000	1.3	63.50
Debtor Z	40,400	1.0	n/a
Total	**$1,000,000**	**2.14**	**n/a**

Impairment per IFRS 9

The provision for credit losses on Debtor Z's receivable of $40,400 will not be any different under IFRS 9. This receivable is credit-impaired and full lifetime ECLs is simply 100% of this receivable without considering the effect of discounting.

A Ltd. has reasonably supportable information that indicates that economic conditions will deteriorate over the next year. Therefore, the historical loss rates were adjusted to reflect this forward-looking information. To determine the ECLs for the other receivables, A Ltd. uses a provision matrix. As previously discussed, the provision matrix uses historically observed default rates over the expected life of the trade receivables, adjusted for current conditions and forward-looking estimates. At every reporting date, A Ltd. reviews and adjusts its historically observed default rates based on current conditions and changes in the future forecasts.

Determining a Loss Allowance for Trade Receivables Using a Provision Matrix *(continued from previous page)*

Based on the expectation that the economic condition is expected to worsen and result in an increase in the potential default rate across the various receivable categories, this increase has been factored in the estimated rates. Therefore, based on the historical loss rate adjusted for forward-looking information, the total provision for ECLs under IFRS 9 would be as follows:

Aging	Trade Receivables Balance ($)	Historical Loss Rates Adjusted for Current Conditions and Forward-Looking Information (%)	Provision for ECLs ($ × %)	Discounted ECL (PV of ECL @3.50%)
Not past due	$748,400	0.50%	$3,742	$3,318
1-30 days	104,600	0.80	837	760
31-90 days	55,200	5.60	3,091	2,836
91-180 days	26,400	8.90	2,350	2,193
181-365 days	15,000	20.30	3,045	2,852
365+ days	10,000	63.90	6,390	6,111
Debtor Z	40,400	100.00	40,400	40,400
Total	**$1,000,000**	**n/a**	**$59,855**	**$58,470**

The calculations assume that the ECLs represented by the historical loss rates adjusted for forward-looking information will occur. Hence, there is an implied probability of 0% that no loss will occur. In addition, the effect of discounting has been considered in estimated ECL due to significant financing impact component that exists with this category of receivables.

Resources

External Resources

- IFRS 9 can be found in Part I of the CPA Canada Handbook - Accounting.
- More information about IFRS 9 and background to the updates can be found in the press release for the standard.
- The IASB's Project Summary provides an overview of the new standard.

IFRS 9 has several Illustrative Examples that accompany, but are not part of, the standard. These examples illustrate the underlying concepts, methodology and computations of the impairment model.

Other MNP Technical Guidance

- IFRS 9 Snapshot
- An Overview of IFRS 9 *Financial Instruments* versus IAS 39 *Financial Instruments: Recognition and Measurement*
- An Overview of the New Financial Asset Classification and Measurement Requirements of IFRS 9 *Financial Instruments*
- An Overview of the Impairment Requirements of IFRS 9 *Financial Instruments*
- An Overview of the Transition Requirements of IFRS 9 *Financial Instruments*
- An Overview of the Hedging Requirements of IFRS 9 *Financial Instruments*
- Auditing Expected Credit Losses for Credit Unions under IFRS 9 *Financial Instruments*

Appendix 1 – Sample Disclosure

Trade and other receivables

	2018	2017
Trade receivables	$ 1,000,000	$ 1,061,400
Loss allowance	(58,470)	(19,750)
Total carrying amount of trade receivables	$ 941,530	$ 1,041,650
Goods and Services Tax recoverable	51,250	53,070
Total carrying amount of trade and other receivables	$ 992,780	$ 1,094,720

Financial Instruments

Credit Risk

Credit risk is the risk of financial loss to the company because a counterparty to a financial instrument fails to discharge its contractual obligations. Credit risk primarily arises from trade receivables.

Risk management process

The Company manages its credit risk by performing regular credit assessments of its customers, providing allowances for potentially uncollectible accounts receivable, considering credit ratings of counterparties.

Credit-impaired financial assets are identified through regular reviews of past due balances and credit assessments of its customers. The Company considers past due information of its balances and information about the customer available through regular commercial dealings.

Measurement of expected credit losses

The Company measures expected credit losses for trade receivables on a group basis. These assets are grouped on the basis of the type of customer, geographic region and business or industry of the customer. Otherwise, expected credit losses are measured on an individual basis.

When measuring lifetime expected credit losses, the Company considers its past credit experience and estimates the timing, probability and magnitude of any cash shortfalls to determine the present value of expected credit losses at the reporting date. Forward-looking information is incorporated into the determination of expected credit loss by considering regional economic journals and forecasts, collecting information available from regular commercial dealings with its customers and other publicly available information and considering the effect such information could have on any assumptions or inputs used in the measurement of expected credit losses or identifying a credit-impaired financial asset.

Write-offs

Financial assets are written off when the customer has filed for bankruptcy and the trustee has indicated that no additional funds will be paid. Where an asset has been written off but is still subject to enforcement activity, the asset remains on a list of delinquent accounts. Where information becomes available indicating the Company will receive funds such amounts are recognized at their fair value.

Exposure to credit risk

The following table sets out information about the credit quality of financial instruments assessed for impairment under IFRS 9 Financial instruments and IAS 39 Financial instruments: recognition and measurement (2017). All classes of financial instruments shown are assessed for impairment in the current year using the simplified approach as permitted in IFRS 9, whereby the loss allowance is always measured at an amount equal to lifetime expected credit losses. The gross carrying amount represents the maximum exposure to credit risk for that class of financial asset.

	2018	2017
Trade receivables		
Not past due	$ 748,400	$ 845,200
1-30 days	104,600	125,000
31-90 days	55,200	42,500
91-180 days	26,400	21,200
181-364 days	15,000	19,000
365+ days	10,000	8,500
Credit-impaired	40,400	-
Total gross carrying amount	$ 1,000,000	$ 1,061,400
Loss allowance	(58,470)	(19,750)
Total carrying amount	$ 941,530	$ 1,041,650

Amounts arising from expected credit losses

Reconciliation of the loss allowance

The following table shows a reconciliation of the opening to the closing balance of the loss allowance by the class of financial instrument. Comparative amounts for 2017 represent the allowance account for credit losses measured under the requirements of IAS 39 Financial instruments: recognition and measurement. All classes of financial instruments shown are assessed for impairment in the current year using the simplified approach permitted in IFRS 9, whereby the loss allowance is always measured at an amount equal to lifetime expected credit losses.

	2018	2017
Trade receivables		
Balance, beginning of year	$ 19,795	$ 12,045
New financial assets originated	8,188	-
Derecognised financial assets	(12,750)	-
Write-offs	-	-
Changes in measurement model or assumptions	2,837	7,750
Credit-impaired	40,400	-
Balance as at year-end	$ 58,470	$ 19,795

Changes in the gross carrying amount of financial instruments

There were no significant changes in the gross carrying amount of financial instruments during the year that contributed to changes in the loss allowance.

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