IFRS 9 Financial Instruments: Impairment

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Monthly Newsletter

Phase 2 of the IFRS 9 project lays out the impairment requirements related to the accounting for expected credit losses on the entity's financial assets and commitments to extend credit.

Different approaches for recognising an impairment

General approach

The general approach will categorise the financial asset into one of three stages, depending on the credit risk changes since initial recognition.

Where the credit risk of the financial asset has **not increased significantly** since initial recognition**,** the entity will recognise a loss allowance equal to an amount which represents 12-month expected credit losses ***(stage 1)***.

12-month expected credit losses are calculated as the lifetime expected credit losses from a possible default multiplied by the probability of that default occurring in the next 12 months**.**

If the credit risk of a financial asset **has increased significantly** since initial recognition, the loss allowance recognised will equal the lifetime expected credit losses ***(stage 2)***.

The financial asset will move to **stage 3** where the credit risk of the asset has increased significantly since initial recognition **and** the asset is credit-impaired due to objective evidence of impairment as at the reporting date (IAS 39 model).

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 the financial asset.

Simplified approach for trade receivables, contract assets and lease receivables

The simplified approach does not require an entity to track the credit risk changes, but rather to recognise a loss allowance based on lifetime estimated credit losses right from origination.

An entity will recognise lifetime expected credit losses for trade receivables or contract assets that do **not** have a significant financing component, or when the entity has not adjusted the amount of consideration for the effects of a significant financing component in terms of IFRS 15:63.

An entity has the option to choose as its accounting policy either the simplified or the general approach on lease receivables recognised in terms of IAS 17, and trade receivables or contract assets that do have a significant financing component.

An entity shall only recognise the cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance for purchased or originated credit-impaired financial assets.

There is a decoupling of interest for assets under stages 1 and 2 (interest calculated on the gross basis), whereas for assets under stage 3, or purchased or originated credit–impaired assets, a credit adjusted effective interest rate is calculated (interest calculated on the net basis).

Determining a significant increase in credit risk

In determining whether there has been a significant increase in credit risk, an entity shall consider whether there has been a change in the risk of default from initial recognition (instead of a change in the amount of the expected credit losses), the expected life of the instrument, and reasonable and supportable information that is available **without undue cost or effort**.

It is assumed that the credit risk has not increased significantly since initial recognition where the credit risk of the instrument is low at the reporting date.

There is a rebuttable presumption that the credit risk has increased significantly since initial recognition when contractual payments **are more than 30 days past due**.

An entity may rely solely on past-due information, only where forward-looking information is not available without undue cost or effort.

Measurement of expected credit losses

An entity shall measure expected credit losses of a financial instrument in a way that reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes, the time value of money, and 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.

The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.