What’s the issue?

IFRS 9 Financial Instruments introduced changes to the calculation of bad debt provisions on trade receivables. Previously, companies provided for amounts when the loss had actually occurred. Under IFRS 9, companies are required to account for what they expect the loss to be on the day they raise the invoice – and they revise their estimate of that loss until the date they get paid. The concept of expected credit losses (ECLs) means that companies are required to look at how current and future economic conditions impact the amount of loss. Credit losses are not just an issue for banks.

ECLs on trade receivables are measured by applying either the general model or the simplified model. This article considers issues particularly relevant to the simplified model, in which ECL is measured at an amount equal to lifetime ECL. For application of the general model, see the following web articles:

- How have economic forecasts used to measure expected credit losses been updated?
- How has the credit risk of borrowers and other debtors been reassessed?

Companies using the simplified model often use provisioning matrices that are based on historical data. Those matrices will have to be adjusted to incorporate reasonable and supportable information that is available at the reporting date, including the impact of the COVID-19 coronavirus outbreak. This may include additional scenarios and the impact of any government support schemes.

In addition, certain assumptions used in the ECL estimate – e.g. about segmentation of a portfolio or the effective interest rate used to discount expected future cash flows – may no longer be appropriate and so may need revising.

Getting into more detail

Reflecting information available at the reporting date

ECLs are measured at an unbiased, probability-weighted amount, using reasonable and supportable information that is available without undue cost or effort at the reporting date. This includes information about past events, current conditions and forecasts of future economic conditions. Because of the short-term nature of trade receivables, many companies may not have needed to consider updating ECL estimates for changes in future economic conditions relative to historic experience. However, they may now need to revisit this given the severe economic impacts of the COVID-19 outbreak. Also, companies may need to consider a longer time horizon – e.g. when payment dates are deferred for a significant period.

[IFRS 9.5.5.17]
IFRS 9 allows the use of practical expedients when measuring ECLs under the simplified approach – e.g. using a provision matrix. A company that applies a provision matrix may be applying segmentation to capture the significantly different historical credit loss experience for different customer segments. However, the segmentation applied in previous periods may no longer be appropriate and may need to be revised to reflect the different ways in which the COVID-19 outbreak affects different types of customers.

Provision matrices are based on historical loss experience but should be adjusted to reflect information about current conditions and reasonable and supportable forecasts of future economic conditions. The COVID-19 outbreak may lead to a significant increase in the loss rate for trade receivables. Therefore, companies will need to consider how the timing and amount of cash flows generated by outstanding trade receivables might be affected and increase loss rates as necessary.

Companies that have credit insurance for their trade receivables should consider how this affects the measurement of ECL and ensure that measurement is consistent with updated loss estimates and any limitations on coverage. The accounting will depend on whether the insurance is considered to be a financial guarantee integral to the contractual terms of the trade receivable. If the guarantee is integral, then it will be included in the measurement of ECL on the trade receivable. If it is not, then separate accounting considerations will apply depending on whether the loss event has occurred. [Insights 7.1.132, 139–140]

**Discount rate**

Trade receivables without a significant financing component are measured on initial recognition at the transaction price determined under IFRS 15 *Revenue from Contracts with Customers*, and do not have a contractual interest rate. This implies that the effective interest rate for these receivables is zero. Accordingly, discounting of cash shortfalls to reflect the time value of money when measuring ECLs is generally not required.

However, if a trade receivable becomes overdue and is then modified to effectively incorporate a significant financing component, then further analysis and judgement may be required, because using an effective interest rate of zero may no longer be appropriate. There may be more renegotiations of trade receivables given the economic impacts of the COVID-19 outbreak. [Insights 7.8.400.30]

**Disclosures**

Under IFRS 7 *Financial Instruments: Disclosures*, a company is required to disclose the nature and extent of risks arising from financial instruments and how it manages those risks. Therefore, a company will need to explain the significant impacts of the COVID-19 outbreak on the risks arising from financial instruments, including trade receivables, and how it is managing those risks. It will need to use judgement to determine the specific disclosures that are both relevant to its business and necessary to meet these disclosure objectives. [IFRS 7.31]

Examples of specific disclosures include the following.

− Information about a company’s credit risk management practices and how they relate to the recognition and measurement of ECLs. A company may have changed its risk management practices in response to the COVID-19 outbreak – e.g. by extending payment terms for trade receivables or by following specific guidance issued by governments in relation to the collection of lease or other payments.

− The methods, assumptions and information used to measure ECLs – e.g. a company may need to explain how it has incorporated updated forward-looking information into measuring ECLs; in particular, how it has:
  - dealt with the challenge of simplified ECL models that were not designed for the current economic shocks;
- calculated any overlays and adjustments to these simplified models;
- reflected the impact of any credit insurance; and
- incorporated the provision of government support that might aid recovery of balances.

Quantitative and qualitative information that enables evaluation of the amounts arising from ECLs. The types of analysis disclosed previously may need to be adjusted or supplemented to clearly convey impacts arising from the COVID-19 outbreak.

Information on the assumptions that the company has made about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in material adjustment within the next financial year. [IFRS 7.35F, 35H–L, IAS 1.125]

Actions for management to take now

When measuring ECLs for trade receivables:

- assess how to incorporate forward-looking information about the impacts of the COVID-19 outbreak;
- consider whether the segmentation applied to measure ECL appropriately captures the different types of customers or regions that are affected in different ways by the economic effects of the COVID-19 outbreak;
- assess whether a trade receivable has been modified and if so whether it continues to be appropriate to use a discount rate of zero; and
- consider how to incorporate the impact of any credit insurance and government support.

References to ‘Insights’ mean our publication Insights into IFRS