How are expected credit losses on trade receivables impacted?

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Companies will need to update provision models to reflect credit losses resulting from economic uncertainty.

What's the issue?

IFRS 9 *Financial Instruments* requires companies to measure impairment of financial assets, including trade receivables, using the expected credit loss model. Accordingly, 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 and economic uncertainty is likely to have an impact on many different receivables.

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 ECLs are measured at an amount equal to lifetime ECLs. For application of the general model, see the following web articles:

- **Does measurement of expected credit losses appropriately reflect the impact of increased economic uncertainty?**
- **Has the impact of increased economic uncertainty on credit risk been appropriately considered?**

Companies using the simplified model often use provisioning matrices that are based on historical data. Those matrices have to be adjusted to incorporate reasonable and supportable information that is available at the reporting date, including economic uncertainty resulting from events such as a natural disaster, geopolitical event or pandemic. This may include considering the need for 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 in the changing economic conditions 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, in some cases the impact of economic and/or geopolitical uncertainty may be immediate and may significantly alter the historical collection patterns for some segments of trade receivables. Companies may need to reassess the impact of external events on future economic conditions and 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 has to be kept under review to reflect the different ways in which economic uncertainties affect different types of customers.

Provision matrices are based on historical loss experience but need to be adjusted to reflect information about current conditions and reasonable and supportable forecasts of future economic conditions. Certain economic uncertainties may lead to a significantly different loss rate for trade receivables compared with prior periods. Companies will need to consider how the timing and amount of cash flows generated by outstanding trade receivables might be affected and amend loss rates as necessary.

Companies that have credit insurance for their trade receivables need to consider how this affects the measurement of ECLs 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 ECLs on the trade receivable. If it is not, then separate accounting considerations will apply depending on whether the loss event has occurred. Companies may also have to consider whether the insurance they hold covers losses arising from external events, such as the war in Ukraine. If there are contractual exclusions, some losses may not be covered. *[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. Certain economic uncertainties may lead to more renegotiations of trade receivables or changes to the effective terms of the receivables. For example this may be the case for receivables impacted by the legal prohibition for Russian businesses to make payments in currencies other than Russian roubles. *[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 economic uncertainties 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 economic uncertainty caused by external events – e.g. by changing payment terms for trade receivables or by implementing a new law or guidance issued by governments.
- 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 issues arising from economic uncertainty;
  - calculated any overlays and adjustments to these simplified models;
  - reflected the impact of any credit insurance;
  - reflected the impact of any changes to law; 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 economic uncertainty.
- 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

When measuring ECLs for trade receivables:

- assess how to incorporate forward-looking information reflecting economic uncertainty;
- consider whether the segmentation applied to measure ECLs appropriately captures the different types of customers or regions that are affected in different ways by the economic uncertainty;
- 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, new legislation and government support.

References to 'Insights' mean our publication **Insights into IFRS®**

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