FINANCIAL REPORTING (EXPECTED CREDIT LOSS MODEL UNDER IFRS 9 FINANCIAL INSTRUMENTS) GUIDANCE 2022

FINANCIAL REPORTING COUNCIL

3rd Floor, Anglo Mauritius House, Intendance Street, Port Louis
Website: http://frc.govmu.org
Email: frc.mauritius@intnet.mu

Introduction

This Financial Reporting (Expected Credit Loss Model of IFRS 9 Financial Instruments) Guidance 2022 ("Guidance on ECL Model'') is issued pursuant to Sections 6(2)(f) and 75 of the Financial Reporting Act.

The Financial Reporting Council (FRC) is operated with a view to encouraging quality reporting by Public Interest Entities and making their financial statements more transparent and comparable.

The Financial Reporting Council (FRC) has taken note of the challenges faced by various companies on the implementation of the ECL model and has come up with a guidance on the ECL Model.

Purpose of this Guidance

The purpose of this Guidance is to assist entities, other than financial institutions and insurance companies, in applying the impairment requirements of IFRS 9, particularly in the light of challenges faced in practice.

Scope of this Guidance

This Guidance is intended for entities other than financial institutions and insurance companies.

Methodology used in the preparation of the Guidance on ECL Model

Following the recommendation by the Council to prepare a guidance for entities other than Financial Institutions and insurance companies, this matter was brought to the attention of the Standard Review Panel (SRP), a Panel of the Financial Reporting Council (FRC). A Sub Group of the SRP ('SRP IFRS Sub Group') was then established to monitor the development of this guidance.

The guidance on ECL model followed the following due process which started in February 2021:

1. Internal Consultation

   A number of internal consultations through meetings of the sub-group members were held to address the challenges faced by entities other than financial institutions and insurance companies in the application of the ECL model.

2. Draft of the Guidance on ECL Model

In May 2021, the SRP IFRS Sub Group together with the staff of the FRC drafted a preliminary draft of the guidance for discussion among members.

Several meetings were held to brainstorm on the preliminary document so as to ensure that

(i) it contains the basics of the ECL model; and

(ii) It simplifies the application of the ECL model for the users of IFRS 9.

The initial draft guidance was examined to ensure that the content of the draft guidance on ECL Model was sensible and in line with the Council's expectations.

3. External Consultation

In October 2021, a draft of the guidance was circularised to stakeholders through a questionnaire so as to obtain the views from all interested parties. The questionnaire included inter alia questions relating to the scope, objective, clarity and complexity of the draft guidance. It also contained a list of open handed and close handed questions. The aim is to evaluate the results of this public consultation for evaluation (both in terms of value relevance and validity) so as to finalise the Guidance on ECL Model.

3.1 Feedback

In November 2021, the FRC had received the responses of the stakeholders to the draft guidance. The feedback received has been accommodated (where relevant) to the draft guidance in a bid to make it more focused to the need of professional practice.

3.2 Evaluation of feedback

In December 2021, FRC with the support of the SRP IFRS Sub Group analysed the feedback received from stakeholders The revised draft of the guidance on ECL Model was then submitted to the SRP IFRS Sub Group for further feedback on the form and contents of the document.

In January 2022, the SRP IFRS Sub Group with the support of FRC staff had evaluated the feedback to identify common observations of stakeholders.

Overall, the respondents supported the content of the draft guidance and made suggestions which related mainly on the application of the ECL Model, additional guidance on the Significant Increase in Credit Risk (SICR) and further explicit guidance regarding assets with a maturity of less than 12 months, interest bearing borrowings and intercompany loans repayable on demand. The result of the assessment of the stakeholders is at Annex(a) of this document.

.

Following the assessment (of responses on the draft) by the SRP IFRS Sub Group, amendments were made to the draft guidance on ECL Model where necessary before issuing the final guidance.

4. Finalisation of the guidance

   In January 2022, the guidance on ECL Model was finalised by the Standard Review Panel.

5. Council Approval

   The final version of the guidance on ECL Model was submitted to the Council for approval in March 2022.

6. Dissemination of the final guidance on ECL Model

   Following the approval of the Council, the guidance is being disseminated to the key stakeholders.

7. The guidance on ECL Model is enclosed.

Prepared by the Financial Reporting Council
March 2022

Feedback on the public consultation

This Annex presents a summary of the key points and other comments arising from the consultation, the analysis and discussion triggered by these comments, and the actions taken to address them if deemed necessary. Changes to the draft guidance on ECL Model had been incorporated when relevant as a result of the responses received during the public consultation.

As part of the due process, FRC had sought the views of the stakeholders on the draft guidance on ECL Model through a questionnaire. The main points raised by the respondents on the draft guidance on ECL Model through the questionnaire were as follows:

a) <u>Content of the guidance on ECL Model</u>

- Guidance with respect to application of the ECL Model

  With respect to the clarity, sufficiency, usefulness, practicalities and applicability of the guidance on ECL Model, some respondents suggesting amendments to the guidance on ECL Model which relate to the following:
  - References to the relevant paragraphs of IFRS 9 for further explicit guidance;
  - Degree to which some entities are more affected by the COVID 19 pandemic; and
  - Estimation of the probability of default that had been used in applying the ECL Model for unlisted and small entities.

- Simplified Approach for trade receivables or contract assets that do not contain a significant financing component

  With regard to the Simplified Approach for trade receivables or contract assets that do not contain a significant financing component and its historical loss period, some respondents were of the opinion that:
  - There should be more guidance on the historical loss period in light of the impact of Covid 19 pandemic; and
  - The historical loss period of 5 years used in the computation of the ECL model was too long.

- Significant Increase in Credit Risk

  The respondents proposed that the following improvements be made to the Significant Increase in Credit Risk (SICR) paragraph of the guidance on ECL Model by:
  - Highlighting the impact of Covid 19 on the SICR assessment;
  - Providing more guidance with respect to assessment of significant increases in credit risk for lending exposures whose contractual cash flows have been renegotiated or modified; and

- Providing guidance on the measurement or assessment of Significant Increase in Credit Risk for financial assets with a maturity of less than 12 months.

- Examples used in the guidance on ECL Model

  With respect to the clarity, sufficiency and relevancy of the examples used in the guidance on ECL Model, some respondents suggested that the guidance on ECL Model could be enhanced by:

  - Providing more examples in the guidance on ECL Model, more specifically with respect to intercompany loans repayable on demand; and
  - Clarifying the assumptions used under Annex 1 - Example of an entity applying provision matrix with groupings applied to trade receivables and Annex II - Example of Impairment of Intercompany Loan (e.g., the Probability of Default, interest rates, historical period).

b) <u>General</u>

This section sought to obtain the views of the participants on the following:

- Operational challenges when implementing the guidance on ECL Model;
- Other issues or concerns with the guidance on ECL model;
- Other information that would provide useful information; and
- Other comments or suggestions about the guidance on ECL model.

In this regard, some respondents suggested that the following improvements could be made to the guidance on ECL Model by:

- Providing more information on the composition of intercompany loans;
- Comparing the computation of the ECL Model for 12-months with that of the lifetime ECL Model;
- Including guidance on the impact of Covid 19 on the calculation of expected credit losses for interest-bearing financial assets; and
- Incorporating other information such as model risk and validation and governance assurance frameworks;

FRC's views on the feedback received on the draft guidance on the ECL Model

In order to finetune the draft guidance on ECL Model, FRC considered the views from the stakeholders. Following the comments received from the stakeholders, an analysis of their replies had been undertaken.

All the above observations which were considered as being fundamental for stakeholders had been incorporated in the guidance on ECL model except for the following:

Sn.	***Summary of responses received***	***FRC's analysis***
1.	The historical loss period of 5 years used in the computation of the ECL model was too long.	FRC is of the view that the selection of the historical loss period for the ECL model is subjective and depends on the individual circumstances of each company.
2.	Other information such as model risk and validation and governance assurance frameworks could be incorporated in the guidance on ECL Model.	It is not in the intention of the guidance on ECL Model to provide for detailed matters in terms of modelling framework.
3.	Clarifying the assumptions used under Annex 1 - Example of an entity applying provision matrix with groupings applied to trade receivables and Annex II - Example of Impairment of Intercompany Loan (e.g., the Probability of Default, interest rates, historical period).	The assumptions used are for entity specific and will vary for each entity. The key message are the steps to be taken in Annexes 1 and II.

Financial Reporting (Expected Credit Loss Model under IFRS 9 *Financial Instruments*) Guidance 2022

THE FINANCIAL REPORTING ACT

Guidance issued by the Financial Reporting Council under Sections 6(2)(f) and 24 of the Financial Reporting Act

TABLE OF CONTENTS

1. Short title

This Guidance may be cited as the **Financial Reporting (Expected Credit Loss Model under IFRS 9 *Financial Instruments*) Guidance 2022**.

2. Interpretation of this Guidance

"Act" means the Financial Reporting Act;
"IFRS" has the same meaning as in the Act;
"IFRS 9" refers to IFRS 9 *Financial Instruments* as issued by the International Accounting Standards Board; and
"Financial institution" has the same meaning as in the Banking Act.

3. Adoption of the International Financial Reporting Standards ("IFRS")

Section 75(1) of the Act stipulates that where a Public Interest Entity ("PIE") is required under any enactment to prepare a financial statement or report, it shall ensure that the financial statement or report follows the financial reporting requirements of this Act or any other relevant enactment, any regulations or rules made under this Act and with the IFRS.

4. Purpose of this Guidance

The purpose of this Guidance is to assist entities, other than financial institutions and insurance companies, in applying the impairment requirements of IFRS 9, particularly in the light of challenges faced in practice, as described in Section 6. As such, this Guidance focuses on the Simplified Approach used for trade receivables or contract assets that do not contain a significant financing component (Section 8), the General Approach for related party loans (Section 9) and the SICR used in the General Approach (Section 12). It also takes into consideration the impact of Covid-19 on ECLs (Section 13).

5. Scope of this Guidance

This Guidance relates to the **Expected Credit Loss Model under IFRS 9 *Financial Instruments***. It is intended for entities other than financial institutions and insurance companies. While the purpose of this Guidance is to assist the entities in applying the impairment requirements of IFRS 9, it does not necessarily address all accounting matters nor all the challenges faced in practice, including those that may be specific to a particular entity or industry. In such cases, the entities should refer to IFRS 9 *Financial Instruments* for detailed information on complex impairment issues.

This Guidance does not preclude users to apply the ECL Model under IFRS 9 which comply with the requirements of IFRS 9, with regards to impairment assessments.

This Guidance scopes out the other requirements of IFRS 9 such as classification and measurement, hedge accounting and disclosures and does not replace or modify IFRS 9.

This Guidance should be read in conjunction with IFRS 9, and in case of conflict IFRS 9 prevails.

6. Key Challenges in the Application of the ECL Model

IFRS 9 became effective for annual periods beginning on or after 1 January 2018 and requires that a loss allowance for ECLs be recognised on financial assets. In practice, the ECL model under IFRS 9 has presented some challenges to entities, including the following:

- Including probability-weighted outcomes, time value of money, or past events, current conditions and forward-looking information appropriately in the ECL model;
- Using relevant and reliable data, and assumptions in the ECL model;
- Assessing how the advent of the Covid-19 pandemic has affected the ECL model; and
- Determining whether a SICR has occurred.

7. Overview of the ECL Model under IFRS 9

The International Accounting Standards Board ("IASB") published the final version of IFRS 9 *Financial Instruments* in July 2014. IFRS 9 replaces IAS 39 *Financial Instruments: Recognition and Measurement* and is effective for annual periods beginning on or after January 1, 2018.

Under IFRS 9, an entity shall recognise a loss allowance for ECLs on the following:

- Financial assets measured at amortised cost;
- Debt instruments measured at fair value through other comprehensive income;
- Certain loan commitments and financial guarantee contracts;
- Lease receivables recognised in accordance with IFRS 16 *Leases*; and
- Contract assets recognised in accordance with IFRS 15 *Revenue from Contracts with Customers*.

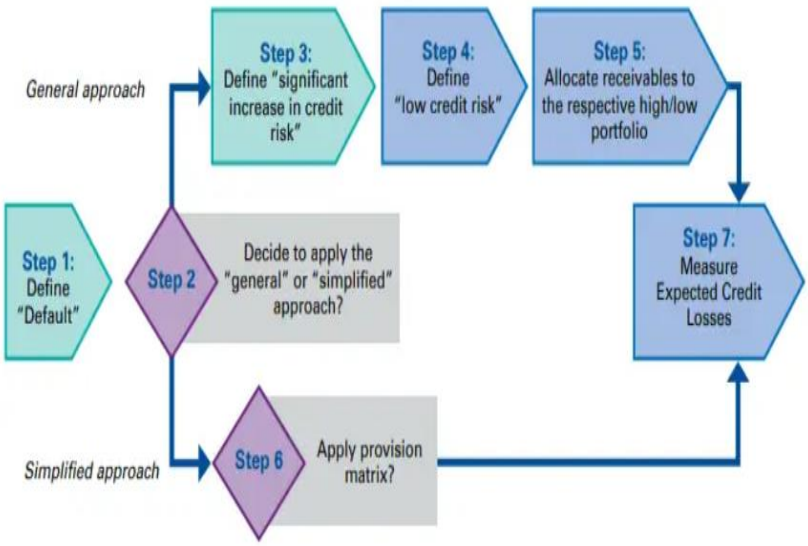
The ECL Model differs from the IAS 39 incurred loss model where a loss event needs not occur before an impairment loss is recognised. Consequently, all financial assets in the scope of the ECL Model generally carry a loss allowance, even those that are newly originated or acquired.

Under IFRS 9, an entity always recognises, at a minimum, 12-month expected credit losses in profit or loss. Lifetime expected losses are recognised on assets for which there is a SICR after initial recognition.

The following decision tree sets out the policy for accounting for impairment under IFRS 9:

The 7 Steps for impairment

Take the following steps to administrate your policy for accounting for impairments of financial assets. Impairment of investments and loans



The 7 Steps for impairment (Annualreporting.info (2021))

Three-stage impairment model ("General Approach")

IFRS 9 establishes a three-stage impairment model ("General Approach"), based on whether there has been a significant increase in the credit risk of a financial asset since its initial recognition. These three stages then determine the impairment to be recognised as ECLs at each reporting date.

Stage	Description	Impairment
1	Credit risk has not increased significantly	12 – month ECLs
2	Credit risk has increased significantly	Lifetime ECLs
3	Credit impaired	Lifetime ECLs

Under the General Approach, impairment is generally measured as either:

- 12-month ECLs - defined as the 'portion of lifetime ECLs that represents the ECLs that result from default events on the financial instrument that are possible within the 12 months after the reporting date'; or
- Lifetime ECLs - defined as the 'ECLs that result from all possible default events over the expected life of the financial instrument'.

The recognition of impairment (and interest revenue) is summarised below:

Figure: Summary of the recognition of impairment (and interest revenue) under IFRS 9

Stage	1	2	3
Recognition of Impairment	12-month expected credit losses	Lifetime expected credit losses	
Recognition of interest	Effective interest on the gross carrying amount		Effective interest on the net carrying amount

Summary of the recognition of impairment (and interest revenue) under IFRS 9 (BDO (2019:51))

IFRS 9 Paragraph 5.5.11 includes a rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due, and the financial asset moves from Stage 1 to Stage 2 and lifetime ECLs are recognised. This presumption can be rebutted if other reasonable and supportable information is available which demonstrates that, even if payments are 30 days or more past due, this may not represent a SICR.

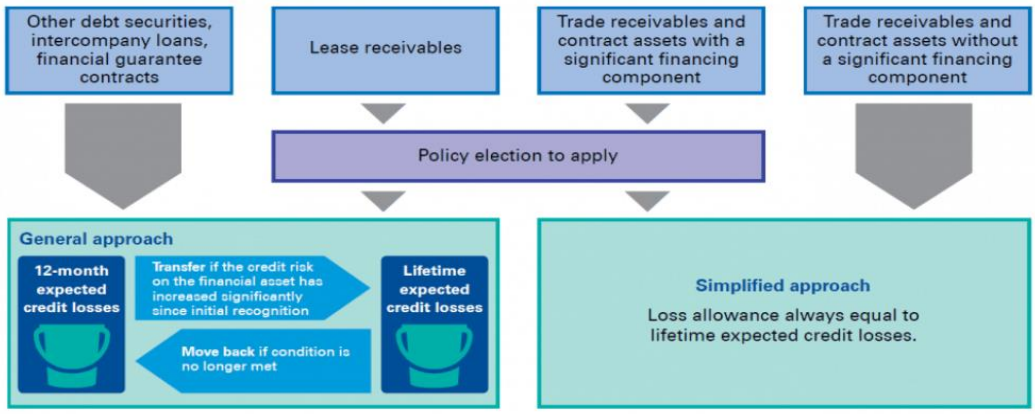
Simplified Approach

IFRS 9, however, requires or allows entities to adopt the Simplified Approach in certain cases, as per the diagram below.

The Simplified Approach allows entities to measure ECLs at an amount equal to the lifetime ECLs without the need to identify SICR. Entities using the Simplified Approach are required to update their loss rates with up-to-date and forward-looking information regularly.

An overview of the policy election to apply the two approaches for ECL calculation is further illustrated in the following flow chart:

Figure: Approaches for ECL calculation



Approaches for ECL calculation (Annualreporting.info (2021))

8. Simplified Approach for trade receivables or contract assets that do not contain a significant financing component

For trade receivables or contract assets that do not contain a significant financing component, the loss allowance should be measured at initial recognition and throughout the life of the receivable at an amount equal to lifetime ECL. As a practical expedient, a provision matrix may

be used to estimate the ECL for these financial instruments. A worked example is provided in Annex I[1].

Using a provision matrix means applying relevant loss rates to the trade receivable balances. This approach is most suitable for non-financial institutions as it may not require sophisticated credit risk management systems in place.

The following steps can be undertaken[2]:

(i) Determine the appropriate groupings

In applying a provision matrix to trade receivables, if material, the portfolio of trade receivables can first be aggregated into groups of receivables that share similar credit risk characteristics. When grouping items for the purposes of shared credit characteristics, it is important to understand and identify what most significantly drives each different group's credit risk.

Examples of criteria that might be used to group assets include geographical region, product type, customer credit rating, collateral or trade credit insurance and type of customer (such as wholesale or retail) (IFRS 9 Paragraph B5.5.35). Segmenting the portfolio of receivables into groups is particularly important when the entity has a diverse customer base with different loss patterns for different customer segments.

When stratifying their receivables into different groupings, entities that sell to customers in different industries will need to take into consideration the fact that some industries have been impacted more than others. It is important to understand how the drivers of credit risk for the underlying receivables have been affected by the Covid-19 pandemic.

(ii) Determine the period over which it is appropriate to observe the entity's loss rate patterns

Once the portfolio is divided into sub-groups, an entity collects historical data for each sub-group. A certain degree of judgement is needed to determine the period over which to collect data that will be reliable and may be representative of future collection. It is important to ascertain the impact of the Covid-19 pandemic on the collection patterns of receivables and to what extent the pre-Covid data provide reliable information. In practice, the data collection period can range from 6 months to 5 years.

The entity should maintain sufficient historical loss data (ideally over at least one full credit cycle) to provide a meaningful analysis of its credit loss experience for use as a starting point when estimating the level of allowances.

The past period of defaults to be considered may be different for different segments of the customers. A lot of judgment is involved to determine the period in which reliable historical data can be obtained and which is relevant to the future period.

[1] PWC, IFRS 9: Expected Credit Loss, August 2014
[2] Deloitte, Clarity in Financial Reporting, July 2018

Due to the uncertainty on account of Covid-19, the decision pertaining to the period over which data should be considered in future will require significant consideration and deliberation.

However, the period should be reasonable and not unrealistically too short or too long.

(iii) Determine the historical loss patterns and the loss rates

By obtaining the observable historic data, the entity can then determine the loss rates for each group of receivables for different ageing categories (for example, not past due, past due 1-30 days, 31-60 days, 90+ days, and so on).

Annex I provides an example of how loss rates can be computed by collecting information on the timing of receipts from debtors and following how credit sales has progressed through the different ageing bands of the receivables.

(iv) Determine how forward-looking information affect the expected loss rates

While the historical loss patterns represent a good starting point to estimate the loss rates, it is necessary to assess how forward-looking information that is available without undue cost or effort can affect the expected loss rates.

Examples of forward-looking information that may be considered include macro-economic factors such as changes in unemployment rate, changes in law and Gross Domestic Product ("GDP") forecasts. Entities will need to consider the continuing impact of Covid-19 in their forward-looking information.

Once the historical rate obtained is adjusted accordingly for forward looking macro-economic factors, the rate then, will be used to measure the expected credit loss in a manner that is consistent with the grouping categories in Step (i).

(v) Compute the ECLs

The ECLs are computed by multiplying the gross receivable balance for each age band of the different sub-group by the loss rates.

Annex I provides a worked example on how a provision matrix can be used.

9. Related Party Loans

Related party loans have the same meaning as in IAS 24 *Related Party Disclosures*. Related party loans can often contain terms that are not consistent with an arm's length lending transaction, for example, interest free or with favourable interest rates, undocumented maturity terms.

Before considering how to apply the requirements of IFRS 9 to related party loans, entities must first consider whether the loan is within the scope of IFRS 9 or another standard. This is because IFRS 9 Paragraph 2.1(a) scopes out 'interests in subsidiaries, associates and joint ventures' that are accounted for in accordance with IAS 27 *Separate Financial Statements* or IAS 28

Investments in Associates and Joint Ventures, that is, at cost less impairment or using the equity method.

In many cases, it will be clear that the loan is a debt instrument that falls within the scope of IFRS 9. For related party loans meeting the criteria for classification at amortised cost or FVTOCI, an entity is required to apply the General Approach for impairment.

A loan is considered to be in default, when there is evidence that the borrower is in significant financial difficulty, such that it will have insufficient liquid assets to repay the loan when due. If the related party loans lack contractual obligations, for example, if repayable on demand or without formal repayment terms, relying on the 90 days past due rebuttable presumption may not be considered appropriate to determine when default has occurred. Instead, we should be assessing whether the borrower has sufficient liquidity to repay the loan and this can be achieved by key performance indicators such as liquidity ratios.

The 30 days past due rebuttable presumption might also not be appropriate, if there is a lack of contractual terms for payments when assessing whether a SICR has occurred for a related party loan. Qualitative factors as well as key performance indicators may have to be considered instead.

As illustrated in the decision tree below, ECLs for loans that are repayable on demand are based on the assumptions that repayment of the loan is demanded at the reporting date:

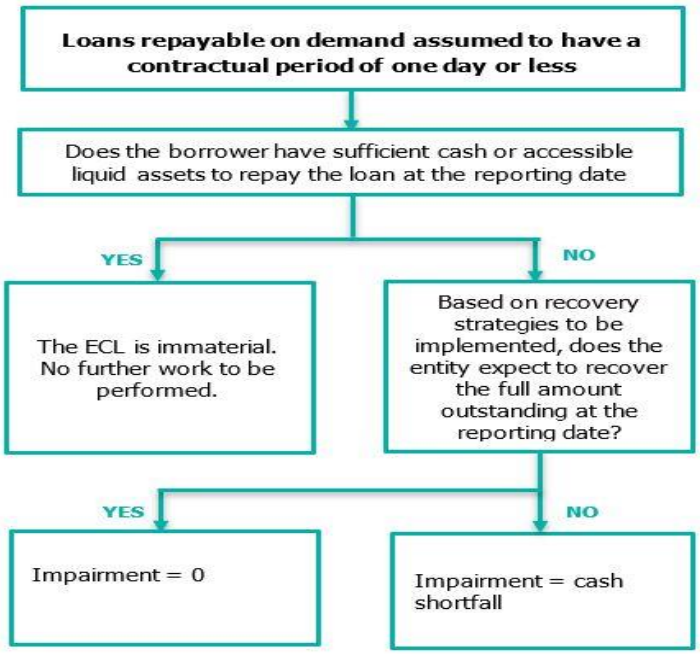
- If the borrower has sufficient accessible highly liquid assets in order to repay the loan if demanded at the reporting date, the ECL is likely to be immaterial.
- If the borrower could not repay the loan if demanded at the reporting date, the lender should consider the expected manner of recovery to measure ECLs. This might be a 'repay over time' strategy (that allows the borrower time to pay), or a fire sale of less liquid assets.
- If the recovery strategies indicate that the lender would fully recover the outstanding balance of the loan, the ECL will be limited to the effect of discounting the amount due on the loan (at the loan's effective interest rate, which might be 0% if the loan is interest free) over the period until cash is realised. If the time period to realise cash is short or the effective interest rate is low, the effect of discounting might be immaterial. If the effective interest rate is 0%, and all strategies indicate that the lender would fully recover the outstanding balance of the loan, there is no impairment loss to recognise.

Considering the 3-stage general impairment model explained above, if the lender uses a PD*LGD*EAD methodology, then the lender of a related party loan that is repayable on demand needs to understand:

- The PD ('probability of default') - the likelihood that the borrower would not be able to repay in the very short payment period;
- The LGD ('loss given default') - the loss that occurs if the borrower is unable to repay in that very short payment period; and
- The EAD ('exposure at default') - the outstanding balance at the reporting date.

Decision Tree

Figure: Decision tree for loans repayable on demand



Decision tree for loans repayable on demand (Nexia (2022))

In the wake of the Covid-19 pandemic, significant judgements will need to be applied in assessing the range of potential outcomes so as to meet IFRS 9's requirements which requires that the ECL reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes, particularly for longer term receivables.[3]

Annexes II and III provide a worked example on how the ECL model can be applied to a related party loan.

10. Other Financial Assets

Other financial assets measured at amortised cost such as lending instruments, debt securities (for example, corporate bonds, national bonds), debt instruments measured at FVTOCI or issued financial guarantee contracts require impairment recognition under the ECL model. For those, the Simplified Approach is not available. This brings extra complexity to the modelling because of the need to manage asset migrations between the 12-month and lifetime ECL measurement buckets in the General Approach.

Annex IV provides an example for estimating ECLs for debt instruments measured at FVTOCI.

11. Assets with a maturity of less than 12 months

Entities would still be required to assess SICR for assets with maturity of less than 12 months even though the provision account for Stage 1 (12-month ECL) and Stage 2 (lifetime ECL) is the same. This is because IFRS 7 *Financial Instruments: Disclosures* requires separate disclosures of

[3] PWC, IFRS 9: What's new in financial instruments accounting for asset management, February 2018

allowance for those receivables that are in Stage 1 and Stage 2. This means that entities need to establish criteria (including systems and processes) for assessing SICR for those short-term receivables where the full three-stage model applies (for example related party receivables).

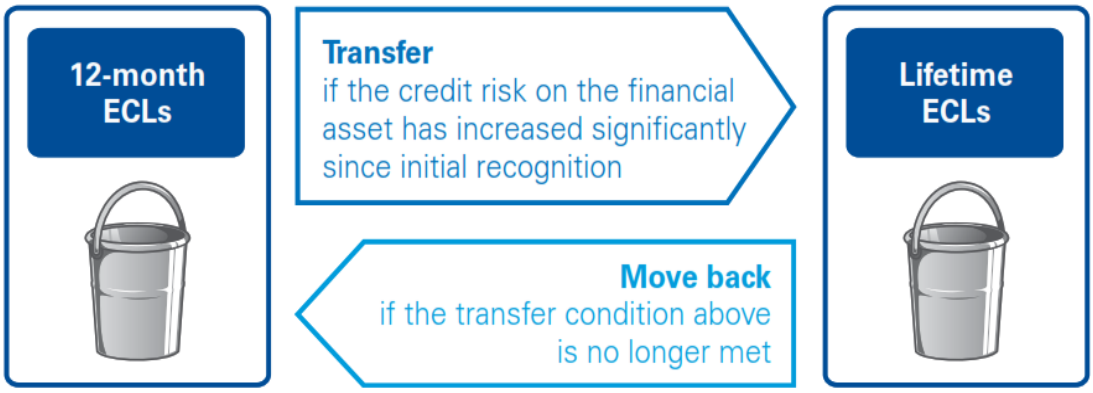
12. Significant Increase in Credit Risk

Under the General Approach, at each reporting date an entity, assesses whether the credit risk on a financial instrument has increased significantly since initial recognition (IFRS 9 Paragraph 5.5.9). This assessment will in turn determine whether a financial instrument should be in Stage 1, where a 12-month ECL is recognised, or Stage 2, where a lifetime ECL is recognised.

Lifetime ECLs are those that result from all possible default events over the expected life of a financial instrument. 12-month ECLs are the portion of lifetime ECLs that represent the ECLs that result from default events on a financial instrument that are possible within the 12 months after the reporting date (IFRS 9 Appendix A Defined terms).

This is particularly important for instruments with a maturity greater than 12 months because lifetime ECL will be higher than 12-month ECL resulting in a higher impairment charge in profit or loss. This is further illustrated in the diagram below:[4]

Figure: Effect on staging requirements, 12-Month versus Lifetime ECL



Effect on staging requirements, 12-Month versus Lifetime ECL (KPMG (2017:27))

While the SICR assessment is particularly important for financial institutions with large lending portfolios, corporates entities are also affected because they too are likely to have financial instruments that fall within the scope of the General Approach. Some of the most common examples include[5]:

- Related party loans and debt instruments, such as bonds held, that are classified at amortised cost or FVTOCI; and
- Certain issued financial guarantee contracts that are not measured at fair value through profit or loss ("FVTPL").

[4] KPMG, IFRS 9: non-financial institutions Part 2, June 2018
[5] BDO UK, Assessing for significant increases in credit risk under IFRS 9, April 2018

Entities may find it challenging and will have to exercise judgement to determine what constitutes a SICR. While financial institutions may develop statistical models to determine a PD measure to assess the risk of default occurring, corporate entities are unlikely to develop such statistical models without undue cost or effort.

IFRS 9 Paragraph B5.5.11 establishes that the estimated PD must include not only past due information, but also forward-looking information (in relation to expected changes in default rates). In this sense, observed past default rates should be adapted to changes in macroeconomic variables.

There are several methods for obtaining a PD:

(i) If market information of quoted inputs is available, the PD can be directly calibrated from quoted credit default swap spreads, quoted bonds yields or by using official credit rating and peer information. In theory, it is assumed that this market information already incorporates forward-looking adjustments.

(ii) A PD can also be obtained by using internal historical default data adjusted by forward-looking information. This data is generally held by large corporate companies.

(iii) Finally, if no market or internal historical information is available, an internal model can be used for estimating the PD based on other companies' default rates, or on information from the Company's financial statements or from other sources.

In certain cases, the SICR assessment may have to be more qualitative in nature, based on an analysis of factors such as those listed below, although whether (and how relevant) a particular factor is, will depend on the specifics of the financial instrument being assessed. In making this assessment, entities need to consider both borrower specific information and information about the general economic and business environment. While much of this information may be available internally, entities may need to seek external sources of information in order to meet the requirements of IFRS 9, for example, incorporating forward-looking macro-economic information.

IFRS 9 Paragraph B5.5.17 contains a list of qualitative factors that may be relevant to the assessment of SICR, including:

- General economic and/or market conditions;
- Operating performance of the borrower and future prospects;
- Significant changes in the expected performance and behaviour of the borrower;
- Breaches of covenant;
- Changes to contractual terms e.g. granting concessions such as interest waivers;
- Cash flow or liquidity issues;
- Credit rating;
- Significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life; and
- Payment delays and past due information.

The relevance of these factors very much depends on the individual facts and circumstances for each financial instrument. For example, monitoring of contractual terms might not be relevant for related party loans granted without contractual payment terms.

As there is no prescribed method of assessing for SICR and no 'bright line' for what constitutes a 'significant' increase, entities need to develop their own policies which must be disclosed in their financial statements. While this is a very judgmental area, there are a number of 'key requirements' that any method used must incorporate:

Figure: Essential considerations when assessing for SICR

Key Requirements	Points to note
Compare credit risk at initial recognition to credit risk at reporting date	• Focus on the *relative increase* rather than the absolute level of credit risk.
Assess changes in risk of default (not loss) over the remaining expected life, that is, changes in the lifetime risk of default	• Default is defined *more widely than payment defaults*, that is, if no payments are due for a certain period, there is still a risk of default. • Effect of collateral /guarantees are *typically excluded.* • Risk of default generally *reduces over time* even if credit risk stays the same.
Incorporate all relevant reasonable and supportable information	• Past, current and *forward-looking information.* • Available without *undue cost or effort.* • Including *borrower specific* and *general and macro-economic* information.

Essential considerations when assessing for SICR (BDO (2018))

SICR focuses on the risk of default arising and the impact of government relief programmes can be considered to determine whether a SICR has arisen.

Modified financial assets

IFRS 9 Paragraphs 5.5.12 and B5.5.25 - B5.5.27 set out the requirements for the assessment of SICR for lending exposures whose contractual cash flows have been renegotiated or modified. In particular, for modifications that do not result in derecognition in accordance with IFRS 9, an entity must assess whether credit risk has increased significantly by comparing (a) the risk of a default occurring at the reporting date based on the modified contractual terms with (b) the risk of default occurring upon initial recognition based on the original, unmodified contractual terms.

Entities should ensure that modifications or renegotiations do not obscure increases in credit risk and thereby cause ECL to be underestimated and to delay the transfer to lifetime ECL for obligors whose credit risk has significantly deteriorated, or inappropriately result in a move from lifetime ECL measurement back to 12-month ECL measurement.

Lending exposures transferred to lifetime ECL that are subsequently renegotiated or modified, and not derecognised, should not move back to 12-month ECL measurement, unless there is sufficient evidence that the credit risk over the life of the exposure has not increased significantly compared with that upon initial recognition.

Operational simplifications

The ECL model includes some operational simplifications in relation to assessing SICR. Three of the most relevant ones to corporates are:

(i) 30 days past due rebuttable presumption

Regardless of the way in which an entity assesses SICR, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

The rebuttable presumption is not an absolute indicator, but is presumed to be the latest point at which lifetime ECL should be recognised even when using forward-looking information.

Risk indicators that can establish whether there has been a SICR vary considerably depending on the nature of the borrower, the product type, internal management methods and external market resources.

The 30 days past due criterion is often applied to retail portfolios because firms usually cannot map the portfolio to external ratings.

(ii) Low credit risk

If a financial instrument is determined to have low credit risk at the reporting date, an entity may assume that the credit risk of the financial instrument has not increased significantly since initial recognition.

Credit risk is considered low if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in conditions in the longer term may, but will not necessarily reduce the ability of the borrower to fulfil its obligations (See Paragraph 6.5 of this Guidance).

An example of a loan that has a low credit risk is one that has an external “investment grade” rating. An entity may use internal credit ratings or other methodologies to identify whether an instrument has a low credit risk, subject to certain criteria.

The low credit risk exemption will be a useful simplification for debt securities that are rated externally because entities can apply investment ratings provided by Moody's (equivalent to or better than Baa3) or Standard & Poor's or Fitch (equivalent to or better than BBB-).

(iii) Use of a change in the 12-month risk of a default as an approximation for change in lifetime risk

IFRS 9 acknowledges that for instruments for which default patterns are not concentrated at a specific point during their expected life, changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of the changes in lifetime risk of a default occurring. In such cases, an entity may use changes in the risk of default occurring over the next 12 months to determine whether credit risk has increased significantly since initial recognition, unless circumstances indicate that a lifetime assessment is necessary.

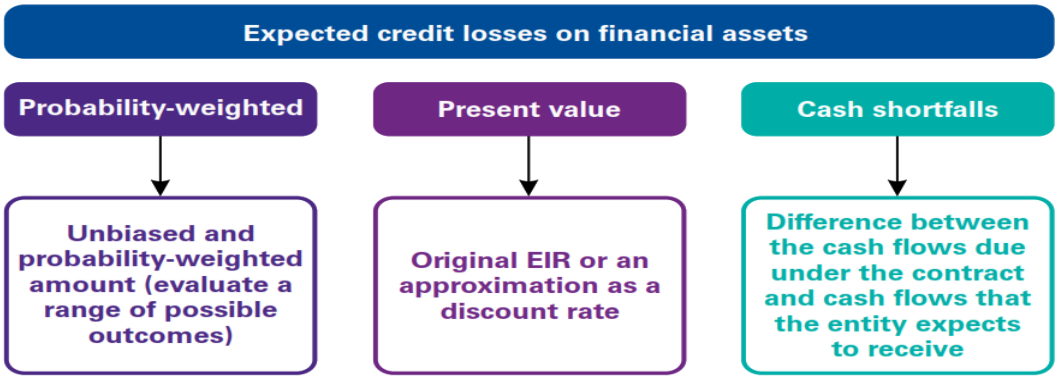
Covid-19 impact on SICR

It is likely to be difficult at this time to incorporate the specific effects of Covid-19 and government support measures on a reasonable and supportable basis. However, changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings. If the effects of Covid-19 cannot be reflected in models, post-model overlays or adjustments will need to be considered. The environment is subject to rapid change and updated facts and circumstances should continue to be monitored as new information becomes available.

13. Measurement of ECL

The measurement of ECL is summarised as follows:

Figure: Estimation of expected credit losses on financial assets



Estimation of expected credit losses on financial assets (KPMG (2017:32))

The staging of a loan, as discussed in the previous section, determines whether the PD is estimated over a 12-month period or the lifetime of the financial asset. In either case, the loss given default is estimated based on the lifetime credit losses occurring from default events in the relevant period (for example, over the next 12 months or the lifetime of the instrument).

This depends on whether there has been a SICR since the date of initial recognition. The credit loss that is calculated on a 12-month basis involves analysis of historical credit losses over 12 months.

But credit loss calculated over the lifetime of the financial asset is derived from historical losses over the life of the asset. The PD calculated on a lifetime basis will be higher than the PD calculated over 12 months. As such, the lifetime ECL will be higher than the 12-month ECL.

Credit losses include cash shortfalls as well as delays in payment, since ECL is a present value calculation (that is, even if an entity expects to recover 100% of a loan and intends to take 18 months longer than the contractual payments, an ECL is recognised).

ECL is an 'expected value', not a single point estimate, meaning it is a weighted average of credit losses based on the respective risks of a default occurring, which must consider at a minimum two scenarios: credit loss occurring and credit loss not occurring.

The effects of Covid-19 will impact the assumptions about the collectability of the financial assets and hence the ECLs. While ECLs are generally expected to increase for many entities, the extent will depend on the specific facts and circumstances of the entity and significant judgement is required.

Not all businesses will be impacted by Covid-19 to the same degree. For example, airlines and tour operators, as well as businesses that are subject to mandatory or voluntary shutdown as a result of 'social distancing' rules, will be impacted to a greater degree than for instance, the major supermarkets and entities manufacturing face masks or protective medical equipment. It is therefore important to 'know your customer' when assessing ECL.

Entities may consider economists' recovery forecasts of different industries, the various government stimulus packages and the organisation's own responses to determine the various possible future scenarios, which will form the basis of assumptions in the estimation of ECL.

The number of potential scenarios included in the ECL calculation may need to increase, due to the effects of Covid-19, along with the respective probability weightings. In addition, it is very likely that there will be a need for additional 'overlays' that are used to adjust the amounts derived from models.

<u>Examples of indicators that the collectability of receivables has deteriorated</u>

Many entities have typically focussed on assessing the recoverability of significantly aged debtors (for example, 120+ days). However, given the unprecedented impact of Covid-19 and its severity differs across various industries, entities may need to analyse whether the recoverability of their debtors has deteriorated regardless of days past due. This requires a detailed understanding of the impact across its customer base.

Some indicators of a deterioration in collectability may include[6]:

- Has there been a material increase in the receivables balance from prior year? If so, why did it increase, for example, is this because of an increase in sales or because of delays in receipts?
- Are customers still paying on time, started paying late or stopped paying altogether? Have debtor days relative to payment terms increased from the prior year?
- Have debtor days increased between February (pre-Covid-19) and June (during Covid-19)?
- Have there been any defaults on amounts due from customers since the beginning of March?
- Have certain customers stopped making payments and have not made any additional orders?
- Are more customers being offered extended payment terms?
- Are aged debtors (for example, 120+ days) approaching their customer limits? Has it been necessary to cut off credit offered to customers?

Where there are indicators that the recoverability of the asset portfolio has deteriorated, entities need to consider how they will incorporate new information about the impact of Covid-19 into their determination of the expected credit losses.

Indicators that the recoverability of trade receivables may not have deteriorated as expected

Some entities may not see a deterioration in the collectability of their receivable's portfolio, even though their customer base may have been impacted by the domestic and global lockdown restrictions. Further analysis may need to be performed to explain to the stakeholders the reasons for this outcome. Some examples include:

- How critical is the organisation to its customer's operations? The more crucial an organisation's supply of goods or services is to their customer's operations, the more likely invoices outstanding at the reporting date will be collected.
- Is the customer's ability to service their debts being supported by Government stimulus or other temporary support measures (such as temporary rent reductions)? If this is the case, collectability of invoices outstanding at the reporting date may still be recoverable.

Entities however, will need to continue to monitor the operations of their customer base. For example, the customer may be less likely to pay its invoices on a timely basis if its business tapers off. Similarly, collectability of invoices from customers supported by Government stimulus package may be negatively impacted when this support ends.

Depending on the long-term impact, loss rates applied at the reporting date could increase further in subsequent reporting periods.

[6] KPMG, COVID-19-how expected is that ECL, June 2020

Thus, the effects of Covid-19 raise several points that should be considered in determining ECL:

ECL Measurement	Impact on ECL model
Interaction with staging requirements (earlier section)	As noted in the earlier section, additional financial assets are likely to migrate from Stage 1 to Stage 2/3, in many (but not necessarily all) cases resulting in an increase in ECL.
Probability of default for defaulted loans	More assets will default, resulting in an increase in ECL as the PD for credit defaulted loans is 100% ECL.
Lifetime ECLs	In determining the effect of Covid-19 on the expected cash shortfalls, lenders should consider the extent to which entities may default on the timing of contractual payments, but may relatively quickly be able to return to compliance with the contractual terms of the instrument. The effects of Covid-19 will result in some entities that will default and never be able to fulfil their contractual obligations, however, many entities may be able to do so if sufficient time is provided. Entities should consider that the determination of a SICR is based on the expected life of financial assets, and that ECL is based on lifetime expected cash shortfalls, and not focus measurement entirely on the 'short-term' shock that may result from the impacts of Covid-19.
Increases in assets at risk prior to default	The EAD (that is, how much the lender has at risk at the time of default) may continue to increase prior to default, as borrowers may continue to draw on revolving facilities such as lines of credit as other sources of income are reduced.
Historical information	Whilst historical loss information could be used as a starting point for estimating ECLs, entities will need to assess whether, and by how much, they expect the Covid-19 pandemic to impact recoverability of their debtor balances based on the available information as at reporting date and adjust their ECLs accordingly.

	The extent to which historical data needed to be adjusted for forward-looking information may have been relatively minor if management felt that past default rates and losses given default were indicative of the future. This may have been the case, given the relatively benign economic environment prior to the Covid-19 global outbreak. It is now highly unlikely that past experience will be indicative of future losses, as the breadth of Covid-19's effects is unprecedented. Therefore, the extent to which forward-looking information will affect historical data, and in consequence ECL measurement, will generally change significantly.
Value of collateral	As ECL considers credit enhancements and security relating to the financial asset, the effects of Covid-19 on the value of assets pledged as collateral must be considered. For example, if Covid-19 results in reductions in the value of commercial real estate, then the ECL on a related commercial mortgage may increase depending on the extent to which the mortgage amount is covered by the fair value of the real estate.
Impact of Government intervention	Government intervention that has been committed to before the period end, may affect whether there is a SICR, and may reduce PD or the LGD. For example, if Government commits to direct financial assistance (for instance, cash payments to individual and businesses), their ability to service financial obligations will increase and the extent to which there is a SICR and the PD will be reduced. In other cases, government assistance may not affect the assessment of whether there has been a SICR or the associated PD, but will decrease LGD (for example, a government guaranteeing a loan in the event that a borrower defaults, does not affect

	the assessment of SICR or the associated PD, but the cash shortfall upon default would decrease).
Modelling the effects of Covid-19	Modelling and estimating the impact of Covid-19 will be challenging, as it is unlike any previously encountered financial crisis or 'stress' on existing systems and processes, especially since IFRS 9 became effective. Entities must undertake 'best efforts' basis for determining the effects and be responsive in adjusting modelling techniques, assumptions and disclosures in subsequent periods as uncertainties change. It will also be necessary to ensure that significantly adverse downside scenarios are built into forecasts while significant uncertainties remain.

Considerations for entities applying the Simplified Approach

A Simplified Approach is required to be applied, where ECL is always measured based on the lifetime ECL for trade receivables if specified criteria are satisfied (the simplified model is optional for lease receivables). In such cases, the 'staging' requirements will not be applicable and the entity may use a provision matrix based on historical default rates, adjusted for forward-looking information.

The effects of Covid-19 will require entities to revisit the adjustments made to historic loss rates and the extent to which they are updated for forward-looking information. In doing so, entities should consider the nature of their trade and/or lease receivables and their customer base. For example, entities may need to consider segmenting their trade receivable balances into sub-portfolios based on customers with higher credit risk (for example, restaurant and hospitality industry) and lower credit risk (for example, medical supply firms) and adjusting historic loss rates at this more granular level.

Considerations for entities other than those applying the Simplified Approach

For other classes, management is required to assess if the risk of default has increased significantly since initial recognition of the receivable, if so, the estimate of ECL is required to be measured using the lifetime ECL Model (sometimes referred to as Stage 2) rather than the 12-month ECL model (referred to as Stage 1).

The estimation of ECL will change depending on the impacts of the outbreak on different counterparties. For example:

- The risk of default will increase depending on the significance of impact to the counterparty;
- The fair value of assets pledged as security may decrease given market conditions; and

- The potential for loss will increase even where high quality security exists.

The implications of Covid-19 may differ depending on the entity specific situation and methodology in assessing ECL.

Made by the Council on 16 March 2022

Example: An entity applying provision matrix with groupings applied to trade receivables

Entity A, a non-financial Company has trade receivables with no significant financing component which amounted to Rs 40,000 at the reporting date. The entity wants to use the Simplified Approach to lifetime ECL suitable for non-financial entities (provision matrix) to calculate ECL for its debtors.

Entity A has assessed those receivables arising from sales in the UK and sales in the rest of the EU are subject to different loss patterns.

Entity A generated sales of Rs 200,000 in the credit assessment period. Out of this Rs 200,000 sales, Rs 120,000 represents sales to the UK and Rs 80,000 to the rest of the EU.

Step 1: Determine the appropriate groupings

In this example, sales are made to two regions and the entity has assessed that they share different credit risk characteristics. Therefore, the portfolio is divided into two groups, the UK and the EU regions.

Step 2: Define the period over which it is appropriate to observe the loss rate patterns

The entity should select a period of sales with historical losses, which are valid representations of loss patterns. For example, data used for a period which is too short may be inadequate while, using too long a period might not be appropriate as significant changes in the marketplace over that period may arise. The data captured over the relevant period should be combined and averages should be calculated (IFRS 9 Paragraph B5.5.53). In this illustrative example, a period of one year is determined to be appropriate.

Step 3: Determine the historical loss patterns and the loss rates

Determine the collection of receivables by the time buckets arising for the selected period of sales.

Unpaid amount amounted to Rs 2,800 for the UK and Rs 1,200 for the rest of the EU (Rs 4,000 in total).

The sales receipts and amounts outstanding at the end of each bucket period for each geographic market are shown in the table below:

UK

Payment period of sales (in days)	**Paid amount (Rs)**	**Paid amount – Cumulative (Rs)**	**Unpaid amount (Rs)**
Within 30 days	(50,000)	(50,000)	70,000
31 - 60 days	(30,000)	(80,000)	40,000

61 - 90 days	(22,400)	(102,400)	17,600
91 - 120 days	(10,800)	(113,200)	6,800
> 121 days	(4,000)	(117,200)	2,800 (loss)

EU

Payment period of sales (in days)	**Paid amount (Rs)**	**Paid amount - Cumulative (Rs)**	**Unpaid amount (Rs)**
Within 30 days	(40,000)	(40,000)	40,000
31 - 60 days	(20,000)	(60,000)	20,000
61 - 90 days	(12,800)	(72,800)	7,200
91 - 120 days	(4,000)	(76,800)	3,200
> 121 days	(2,000)	(78,800)	1,200 (loss)

The loss rates for each market are calculated by dividing the respective loss by the amount outstanding at the beginning of each bucket period, as shown in the table below:

UK

	Current sales	**Amount outstanding after 30 days**	**Amount outstanding after 60 days**	**Amount outstanding after 90 days**	**Amount outstanding after 120 days***
Ageing profile of sales: [1]	Rs 120,000	Rs 70,000	Rs 40,000	Rs 17,600	Rs 6,800
Loss: [2]	Rs 2,800	Rs 2,800	Rs 2,800	Rs 2,800	Rs 2,800
Loss rate: [2] / [1]	2.33%	4.00%	7.00%	15.91%	41.18%

EU

	Current sales	Amount outstanding after 30 days	Amount outstanding after 60 days	Amount outstanding after 90 days	Amount outstanding after 120 days*
Ageing profile of sales: [1]	Rs 80,000	Rs 40,000	Rs 20,000	Rs 7,200	Rs 3,200
Loss: [2]	Rs 1,200	Rs 1,200	Rs 1,200	Rs 1,200	Rs 1,200
Loss rate: [2] / [1]	1.50%	3.00%	6.00%	16.67%	37.50%

* In the above example, the last bucket refers to amount outstanding after 120 days. If management has more information, the buckets can be further expanded, depending on each entity's own circumstances.

Step 4: Determine how forward-looking information affect expected loss rates

The historical loss rates 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.

For Entity A, the increase in unemployment rates is expected to increase the loss of Rs 2,800 to Rs 3,000 for UK and Rs 1,200 to Rs 1,500 for EU.

Provided that sales and the payment profiles are expected to remain materially the same as for the historical sales period, the expected loss rates are recalculated as illustrated below:

UK

	Current sales	Amount outstanding after 30 days	Amount outstanding after 60 days	Amount outstanding after 90 days	Amount outstanding after 120 days
Ageing profile of sales: [1]	Rs 120,000	Rs 70,000	Rs 40,000	Rs 17,600	Rs 6,800
Loss: [2]	Rs 3,000	Rs 3,000	Rs 3,000	Rs 3,000	Rs 3,000
Loss rate: [2] / [1]	2.50%	4.29%	7.50%	17.05%	44.12%

EU

	Current sales	Amount outstanding after 30 days	Amount outstanding after 60 days	Amount outstanding after 90 days	Amount outstanding after 120 days
Ageing profile of sales: [1]	Rs 80,000	Rs 40,000	Rs 20,000	Rs 7,200	Rs 3,200
Loss: [2]	Rs 1,500	Rs 1,500	Rs 1,500	Rs 1,500	Rs 1,500
Loss rate: [2] / [1]	1.88%	3.75%	7.50%	20.83%	46.88%

Step 5: Calculate the ECL using the expected loss rates

The adjusted loss rate estimates obtained at Step 4 are then applied to the ageing profile of trade receivables to calculate the ECL of each portfolio.

A fall in value of Sterling during the year led to an increase in sales to the rest of the EU. Trade receivables stood at Rs 40,000 at year end. Out of the total receivables, Rs 16,000 relate to the UK and Rs 24,000 to the rest of the EU.

UK

	Total receivables	Current	30 - 60 days	61 - 90 days	After 90 days	After 120 days
Trade receivable balances at reporting date: [1]	Rs 16,000	Rs 6,000	Rs 4,000	Rs 3,000	Rs 2,000	Rs 1,000
Loss rate: [2]	-	2.50%	4.29%	7.50%	17.05%	44.12%
Expected credit loss: [1] x [2]	Rs 1,329	Rs 150	Rs 171.6	Rs 225	Rs 341	Rs 441.2

EU

	Total receivables	Current	30 - 60 days	61 - 90 days	After 90 days	After 120 days
Trade receivable balances at reporting date: [1]	Rs 24,000	Rs 12,000	Rs 6,000	Rs 3,000	Rs 2,000	Rs 1,000
Loss rate: [2]	-	1.88%	3.75%	7.50%	20.83%	46.88%
Expected credit loss: [1] x [2]	Rs 1,561	Rs 225.6	Rs 225	Rs 225	Rs 416.6	Rs 468.8

The lifetime ECL for both groupings totals Rs 2,890.

Example: Impairment of related party loan with fixed terms

Mr. X is a director of Company A and is also the sole shareholder of Company B. Company B is therefore a related party to Company A.

- On 1 January 20X1, Company A provided a loan of Rs 100,000 to Company B for four years at an annual interest rate of 10%.
- On 31 December 20X2, Company B is expected to have cash flow problems in future due to a deterioration in economic conditions.
- On 31 December 20X3, the loan is extended for another three years because Company B is in financial difficulty and does not have enough cash to repay the loan.

How should the loan be accounted for under the three-stage expected loss model?

The probability of default given below are just assumptions used for this worked example.

Each Company would have to determine their probability of default depending on own circumstances.

As at 31 December 20X1:

- The loan is in Stage 1;
- Assuming there is a 1% probability of Company B defaulting in the next 12 months and, if there is a default, Company A will not get any amount back (100% loss); and
- Company A has to:
  (a) Recognise a provision of Rs 1,000 (1% x Rs 100,000); and
  (b) Recognise interest on the gross carrying amount of the loan (Rs 100,000 x 10%).

As at 31 December 20X2:

- The loan is in Stage 2;
- The probability that Company B will default over the remaining life of the loan is estimated at 35% as its credit risk has increased significantly as Company B is expected to have cash flow problems in future due to a deterioration in economic conditions;
- It is noted that in case of default, a 100% loss will be incurred; and
- Company A has to:
  (a) Recognise a provision of Rs 35,000 (35% x Rs 100,000); and
  (b) Recognise interest on the gross carrying amount of the loan (Rs 100,000 x 10%).

As at 31 December 20X3:

- The loan is in Stage 3;
- Company A estimates that the probability of default over the remaining life of the loan is 60%, as Company B is in financial difficulty, is not able to repay the loan and relies on an extension of the loan for three years. The loan is therefore credit impaired;
- If there is a default, there will be a 100% loss; and
- Company A has to:
  (a) Recognise a provision of Rs 60,000 (60% x Rs 100,000); and

(b) Recognise interest on the net carrying amount of the loan (Rs 40,000 x 10%) from the beginning of the next reporting period.

Example: Impairment testing of related party loan on demand

Parent (X) makes an interest free loan of Rs 1m to its subsidiary (S). There is a written agreement in place which provides that the loan is repayable on-demand. S has no other debt obligations or credit facilities, is adequately capitalised and has a current ratio of 1:1. Cash flow forecasts for the next 3 years indicate net cash inflows in each year.

The loan is initially measured at its fair value. As the loan is repayable on-demand, its fair value is the transaction price and the effective interest rate (EIR) is zero.

Assessing probability of default and changes in credit risk

In determining a default event, X considers a range of factors that would indicate that the loan is in default, and not only when the loan is 90 days past due. The factors considered relevant are the availability of liquid assets when the loan is called.

In assessing whether an increase in credit risk relative to the position at initial recognition is indicated, X decides that the availability of liquid assets at the reporting date together with forward-looking information is most relevant. Therefore, X decides to rely on its review of S's management accounts and cash flow forecasts when assessing credit risk. X judges that a current ratio of 0.8:1 or less or a forecast net outflow of cash in any of the next 3 years is an indication that credit risk has increased significantly.

However, whether there has been a SICR (which determines whether 12-month or lifetime ECLs apply) is largely irrelevant because the maximum period over which ECLs can be measured is the maximum contractual period (including extension options) over which the lender has a contractual obligation to extend credit. This is the period over which the entity is exposed to credit risk, and not a longer period. Given the loan is repayable on-demand, the maximum contractual period, and hence period of exposure to credit risk, is 1 day. Credit losses arising from the risk of a default that may occur after 1 day are not included.

How does X measure its impairment losses using the General Approach?

At the reporting date, S's management accounts indicate that it does not have sufficient liquid assets to repay the loan. Accordingly, X estimates that the probability of default would be 100% because if demanded, S would default.

In measuring the expected loss on default, X considers the expected manner of recovery. X judges that to maximise recovery of the loan it would allow S to continue trading for 2 years, to fund repayment of the loan rather than arrange a fire sale of the less liquid assets.

Based on this strategy, and considering likely economic scenarios, X expects to recover Rs900k of the loan (Note 1). This amount is arrived at, after discounting the expected cash flows for each possible outcome over the 2-year period to the reporting date using the EIR. As the loan is repayable on-demand, the EIR is zero and therefore the effect of discounting is nil (Note 2).

X therefore recognises a loss of 100% x (Rs1m-Rs900k) = Rs100k.

Notes:

1. The Rs900k reflects the probability-weighted amount after evaluating an unbiased range of possible outcomes. It reflects neither a worst-case nor a best-case scenario and therefore the amount of the loss can never be 100% or 0%; instead it must reflect both the possibility that a credit loss occurs and the possibility that no credit loss occurs even if this is very low (IFRS 9 Paragraphs 5.5.17a and 18, Paragraph B5.5.41-43).

2. IFRS 9 Paragraph 5.5.17b requires the outcomes to reflect the expected timing of recovery (in this case, 2 years past due). Had the EIR in this example been other than zero, the effect of discounting would impact the amount of the impairment. However, such effect may be immaterial over a 2-year period.

Example: Estimating ECL for Fair Value through Other Comprehensive Income ("FVTOCI")

An entity purchases a debt instrument with a fair value of Rs 1,000 on 15 December 20X0 and measures the debt instrument at FVTOCI. The instrument has an interest rate of 5% over the contractual term of 10 years, and has a 5% effective interest rate. At initial recognition, the entity determines that the asset is not a purchased or originated credit-impaired asset.

	Debit	Credit
Financial asset – FVTOCI	Rs 1,000	
Cash		Rs 1,000

On 31 December 20X0 (the reporting date), the fair value of the debt instrument has decreased to Rs 950 as a result of changes in market interest rates. The entity determines that there has not been a SICR since initial recognition and that ECL should be measured at an amount equal to 12-month ECL, which amounts to Rs 30. For simplicity, journal entries for the receipt of interest revenue are not provided.

	Debit	Credit
Impairment expense (P&L)	Rs 30	
Other comprehensive income	Rs 20	
Financial asset – FVTOCI		Rs 50

The cumulative loss in other comprehensive income at the reporting date was Rs 20. That amount consists of the total fair value change of Rs 50 (that is, Rs 1,000 – Rs 950) offset by the change in the accumulated impairment amount representing 12-month ECLs that was recognised (Rs 30).

On 1 January 20X1, the entity decides to sell the debt instrument for Rs 950, which is its fair value at that date.

	Debit	Credit
Cash	Rs 950	
Financial asset – FVTOCI		Rs 950
Loss on sale (P&L)	Rs 20	
Other comprehensive income		Rs 20

Analysis: When calculating ECL on financial assets classified in the FVTOCI category, movements in the ECL provision will impact profit or loss. Under the model, impairment charges in profit or loss will always occur earlier as compared to current IAS 39 guidance, and this is no different for financial assets classified in the FVTOCI category.

References

Annualreporting.info (2021). IFRS 9 ECL Model Best Read - Impairment of Investments and Loans – Annual Reporting. Available from: https://annualreporting.info/impairment-of-investments-and-loans/ [Online] [Accessed 20 July 2021].

BDO (2018). Assessing for significant increases in credit risk under IFRS 9. Available from: https://www.bdo.co.uk/en-gb/insights/audit-and-assurance/ifrs-us-gaap-and-international-gaap/assessing-for-significant-increases-in-credit-risk-under-ifrs-9. [Online] [Accessed 20 July 2021].

BDO (2019). IFRS IN PRACTICE 2019 IFRS 9 Financial Instruments. Available from: https://www.bdo.global/getmedia/70b2ea49-d800-4ba2-911d-03e23f5bbfb7/IFRS9_FinancialInstruments_screen.aspx. [Online] [Accessed 20 July 2021].

BDO (2020). Impairment Implications of Covid-19 (IFRS 9 Financial Instruments). Available from: https://www.bdo.global/getmedia/aa095ab7-4b30-4ede-9796-b28cd8e19dff/IFRB-2020-09-Impairment-implications-of-COVID-19-(IFRS-9-Financial-instruments).aspx. [Online] [Accessed 20 July 2021].

BDO (2022). Coronavirus impacts on the accounting for financial instruments under IFRS 9 and contract assets under IFRS 15. Available from: https://www.bdo.com.au/en-au/accounting-news/accounting-news-april-2020/coronavirus-impacts-on-the-accounting-for-financial-instruments. [Online] [Accessed 12 January 2022].

Deloitte (2018). Clarity in Financial Reporting. Available from: https://www2.deloitte.com/content/dam/Deloitte/au/Documents/audit/deloitte-au-audit-applying-expected-credit-loss-model-trade-receivables-using-provision-matrix-030519.pdf. [Online] [Accessed 26 July 2021].

European Banking Authority (2017). Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses. Available from: https://www.eba.europa.eu. [Online] [Accessed 12 January 2022].

Grant Thornton (2020). Accounting implications of coronavirus (Covid-19). Available from: https://www.grantthornton.com.au/globalassets/1.-member-firms/australian-website/services/audit/pdfs/gtal_2020_accounting-implications-of-covid-19.pdf. [Online] [Accessed 12 January 2022].

International Accounting Standards Board (2014), IFRS 9, Financial Instruments.

IFRS (2020). IFRS 9 and Covid-19. Available from: https://cdn.ifrs.org/content/dam/ifrs/supporting-implementation/ifrs-9/ifrs-9-ecl-and-coronavirus.pdf. [Online] [Accessed 12 January 2022].

KPMG (2017). IFRS 9 for corporates. Available from: https://assets.kpmg/content/dam/kpmg/xx/pdf/2017/09/ifrs9-for-corporates.pdf. [Online] [Accessed 20 July 2021].

KPMG (2018). IFRS 9: non-financial institutions Part 2. Available from: https://home.kpmg/mt/en/home/insights/2018/06/ifrs9-for-non-financial-institution-part-2.html. [Online] [Accessed 26 July 2021].

KPMG (2019). IFRS 9 creates challenges for corporates. Available from: https://advisory.kpmg.us/articles/2019/ifrs-9-corporates.html. [Online] [Accessed 12 January 2022].

KPMG (2020). Covid-19- how expected is that ECL. Available from: https://home.kpmg/au/en/home/insights/2020/06/20ru-014-covid-19-expected-credit-loss.html. [Online] [Accessed 26 July 2021].

Nexia (2022). IFRS 9: ECL on intercompany loans repayable on demand. Available from: https://www.nexia-sabt.co.za/sabtips/ifrs-9-ecl-on-intercompany-loans-repayable-on-demand. [Online] [Accessed 12 January 2022].

PKF (2021). IFRS 9: the two ways of calculating ECLs. Available from: https://www.pkf-l.com/insights/ifrs-9-the-two-ways-of-calculating-ecls. [Online] [Accessed 26 July 2021].

PWC (2014). IFRS 9: Expected credit losses. Available from: https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-9/ifrs-in-depth-expected-credit-losses.pdf. [Online] [Accessed 20 July 2021].

PWC (2018). IFRS 9: What's new in financial instruments accounting for asset management. Available from: https://www.pwc.com/gx/en/audit-services/ifrs/publications/financial-instruments-accounting-for-asset-management.pdf. [Online] [Accessed 26 July 2021].

PWC (2019). IFRS 9 impairment practical guide: intercompany loans in separate financial statements. Available from: https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-9/ifrs-9-impairment-intercompany-loans-in-depth.pdf. [Online] [Accessed 12 January 2022].

RSM IFRS Advisory Committee (2019). Available from: https://www.rsm.global/sites/default/files/media/Ideas%20and%20insight/IFRS/RSM%20Reporting/feb_2019_ifrs_9_-_intercompany_loan_receivables.pdf. [Online] [Accessed 12 January 2022].

RSM IFRS Advisory Committee (2020). RSM INSIGHT: APPLYING IFRS 9 FINANICAL INSTRUMENTS. Available from: https://www.rsm.global/sites/default/files/media/rsm_insight_applying_ifrs_9_-_finanical_instruments.pdf. [Online] [Accessed 20 July 2021].

Spanish Accounting Review (2020). IFRS 9 Expected Loss: A Model Proposal for Estimating the Probability of Default for non-rated companies. Available from: https://revistas.um.es/rcsar/article/download/370951/283811. [Online] [Accessed 12 January 2022].