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# MFRS Hot Topics

## Trade receivables and impairment (Part 2)

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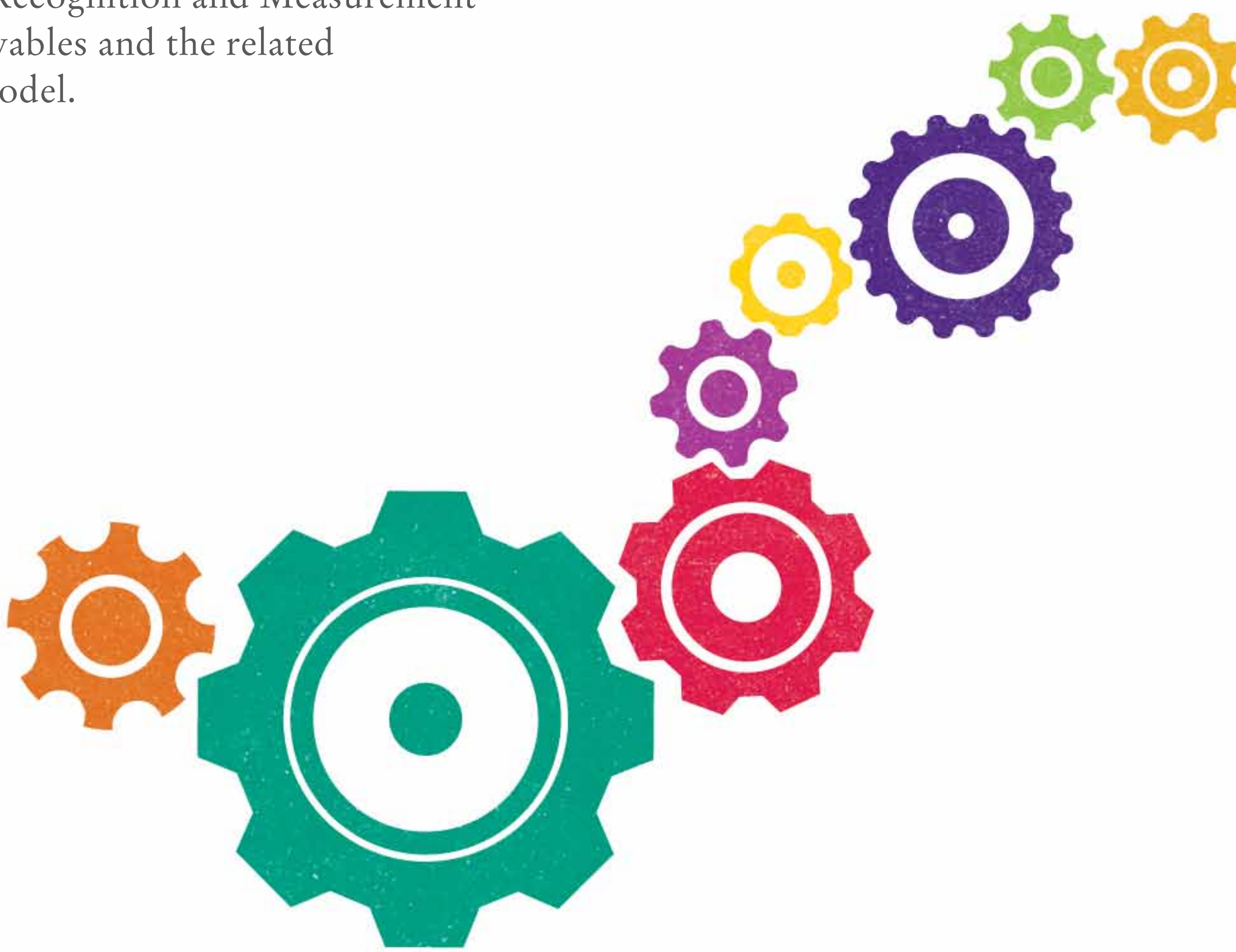
Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue provides the continuation of the requirements of MFRS 139 Financial Instruments: Recognition and Measurement on trade receivables and the related impairment model.



Application of MFRS 139's impairment model to trade receivables. This Hot Topic applied only to short-term trade receivables that have no stated interest rate that are measure at amortised cost subsequent to initial recognition.

We have discussed the individual impairment assessment of trade receivables in Part 1. In Part 2 of this Hot Topics, we will focus on the collective impairment assessment followed by flowchart for impairment review of portfolio of trade receivables. The last section of this publication covers the issue of credit losses and dispute risk.

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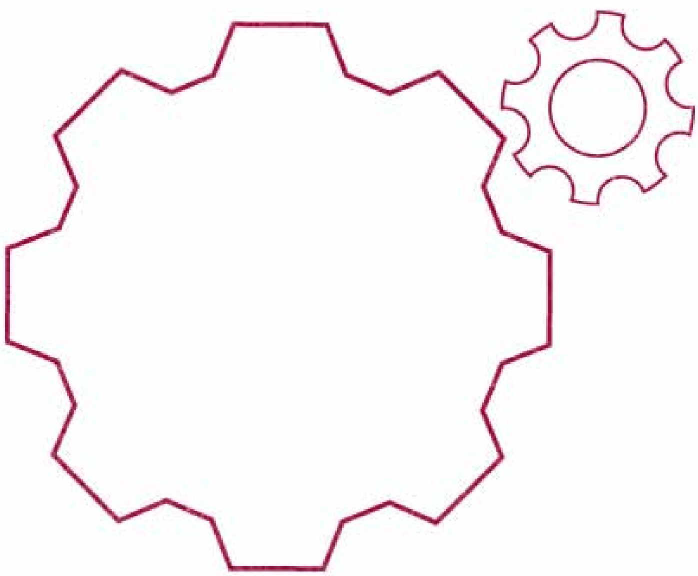


# Collective assessment

As noted in the prior issue (Part 1 - January 2014 Hot Topics), MFRS 139 usually requires a collective assessment of trade receivables in addition to any individual assessments. In carrying out the collective assessment:

- receivables should be grouped on the basis of common credit risk characteristics (MFRS 139.AG87). The basis for the groupings will vary between entities. Possible bases include internal or external credit grading, geographical location and past due status
- items are removed from the collective assessment once information becomes available that specifically identifies losses on individual items (MFRS 139.AG88)
- any items that have been reviewed individually and found not to be impaired are included in the collective assessment (MFRS 139.64).

In a collective assessment, relevant indicators of impairment might include:

- adverse changes in payment status such as a significant deterioration in the 'ageing profile' of the portfolio (MFRS 139.59(f)(i))
- economic factors such as an increase in unemployment rates, bankruptcies and/or industry conditions that correlate with default rates (MFRS 139.59(f)(ii)).

The collective assessment differs from the individual assessment in that impairment losses are estimated on a portfolio basis (once there is evidence of impairment). As result an individual item that is assessed and found not to be impaired might nonetheless give rise to an impairment loss when included in the collective assessment. This requirement has proved controversial and is discussed at length in MFRS 139's Basis for Conclusions.

Formula-based or statistical methods may be used to determine impairment losses in a collective assessment (MFRS 139.AG92). However, any formula should be consistent with the basic impairment model.

**Formula for basic impairment model:**

- incorporate the time value of money (noting however that impaired short term receivables are not discounted if the effect is immaterial (MFRS 139.AG84))
- consider the cash flows over the full remaining life of the asset(s)
- consider the age of the portfolio
- not create a loss on initial recognition.

For many entities the ageing profile of receivables is the most readily available evidence of potential impairment of a group of trade receivables. Entities that are able to correlate credit losses with past due status should be able to estimate future cash flows using this information. However, establishing this correlation might require quite extensive analysis. For example, an entity might wish to estimate the probability of default for receivables in a 61-120 days past due category. To achieve this it might be necessary to analyse a sample of previous 'aged-debtors listings' going back a number of years and determine the proportion of receivables in the 61-120 days past due category that ultimately paid or defaulted.

In some industries (such as credit card lenders and utilities supplying domestic customers) extensive historical loss credit loss experience and sophisticated credit monitoring systems are usually maintained. Such industries are also likely to experience substantial credit losses, increasing the need for comprehensive data to assess impairment. The extent of data and supporting analysis should reflect the extent of credit risk to which an entity is exposed. Assessing impairment involves judgements and estimates and it is not necessary to strive for an artificial degree of precision. Management should however review and if necessary refine its procedures and assumptions based on actual loss experience as it becomes available.

**Illustration 1**

An entity has a large number of customers. It performs credit checks of all new customers. Management assigns credit limits based on these checks and subsequent trading history. Stated credit terms are 30 days although the average collection time is 45 days. Credit losses are generally moderate at 1-2% of amounts invoiced. However, management has compiled historical data indicating that loss rates are: 10% once amounts become 0-30 days past due, 20% for 31-60 days, 40% for 61-120 days etc. For these past due amounts, management estimates that the payments are received on average within 30 days (taking into account only those amounts that are ultimately received). Management has also received specific information that a few customers have ceased trading or filed for creditor protection. Receivables are recorded at invoice amount on initial recognition. Management estimates that a market rate for short-term, unsecured lending to its customers is 10%.

Receivables from customers that have ceased trading or filed for creditor protection should be assessed separately. In the likely event that they are found to be impaired, these receivables are not included in the collective assessment. In the collective assessment, the inclusion of some of the receivables in the past due categories indicates impairment. Management is able to correlate credit losses with past due status. Accordingly the different past due categories can be used as the basis of grouping receivables into common credit risk characteristics. The historical loss data can also be used to estimate future cash flows and to quantify impairment losses.

The effect of discounting the impaired receivables portfolio continues to be immaterial hence no discounting is required. Management's loss assumptions should be monitored and refined when necessary as additional loss experience becomes available.

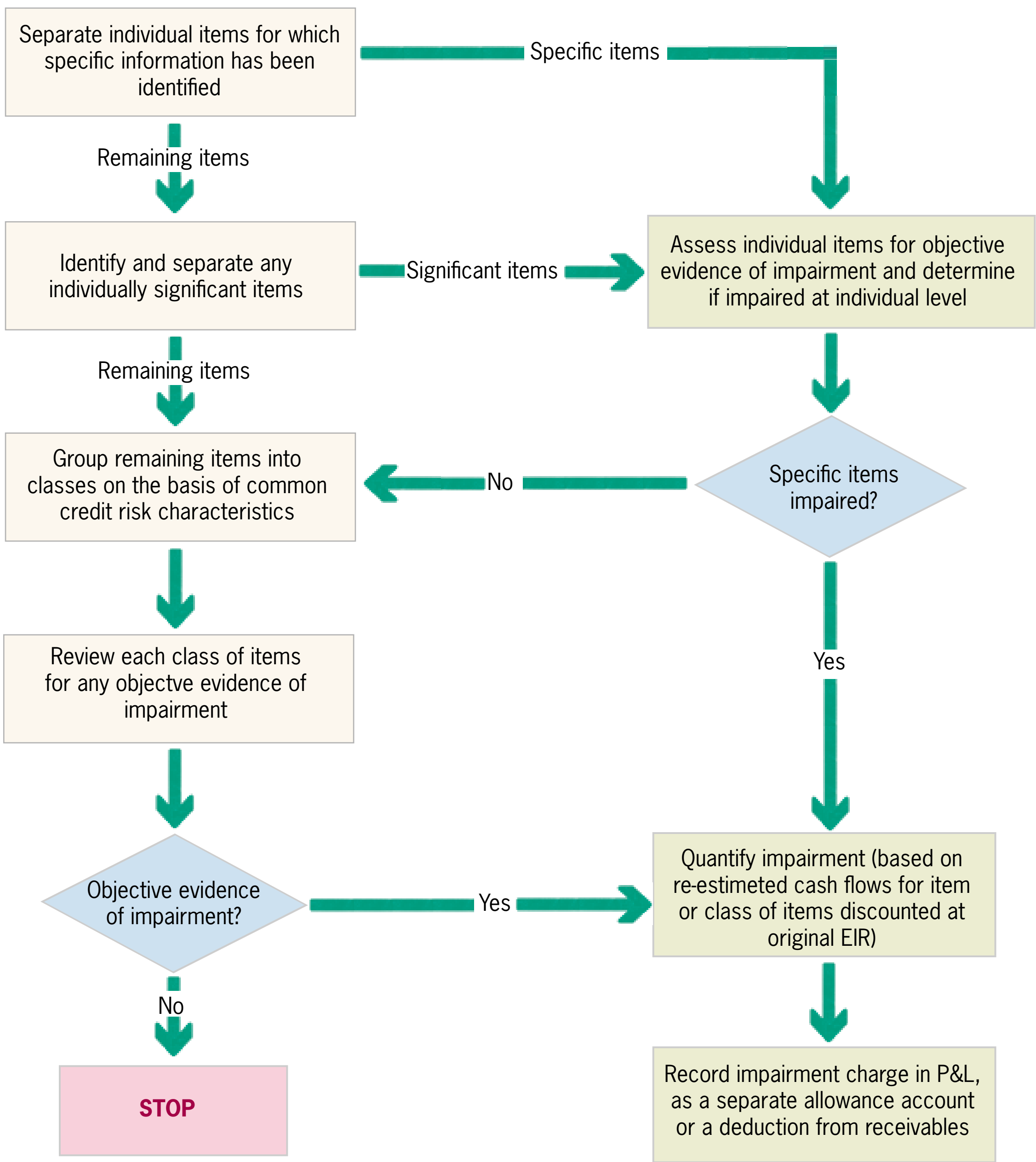
*The flowchart in the next page summarises the relationship between the individual and collective impairment assessment.*

### Reversal of impairment losses

If the amount of an impairment loss decreases in a subsequent period, and the decrease relates to an event occurring after the impairment was recorded, the impairment loss is reversed through the income statement. The carrying amount of the receivable should not be increased above what the amortised cost would have been without the impairment loss (MFRS 139.65).

In practice, this will not often be relevant for trade receivables. More commonly an impaired trade receivable will either be paid or will continue to be regarded as impaired.

# Flowchart for impairment review of portfolio of trade receivables



# Credit losses and dispute risk

For many entities, customers sometimes refuse to pay amounts invoiced due to disagreements over the goods or services supplied, invoicing errors and other types of dispute. Some entities set up credit note provisions or similar reserves to cover these situations. Non-payment due to a genuine commercial dispute is not an impairment for MFRS 139 purposes. Instead, dispute risk relates to uncertainty that a valid financial asset exists in the first place (given that a financial asset arises from a contractual entitlement). Historical loss credit loss experience should therefore exclude reversals and write-offs resulting from genuine commercial disputes.

Dispute risk should, where significant, be considered in determining whether revenue and associated receivables should be recognised.

**Illustration 2**

Entity A is a distributor of car parts. It has a large number of customers. Customers range from large companies with strong credit standing to small businesses and individuals with limited credit history. For credit control purposes, Entity A groups its customers into three categories:

**Group 1 - government and large companies**

Entity A has historically experienced minimal credit losses for this group. On average, customers in this category settle their debts in approximately 45 days of invoice. However, some of these customers can be slow to pay. Management estimates that a market rate for short-term, unsecured lending to this category of customer is 4%. Because of the lack of a history of credit losses with this group, management is unable to identify any specific loss events that correlate with credit losses. Receivables from these customers are generally individually significant.

**Group 2 - medium-size companies and established customers with reliable credit histories**

Entity A has historically experienced credit losses of around 1-2% for this group. On average, customers in this category settle their debts in approximately 45 days of invoice. However, it is not uncommon for these customers to pay up to 60 days late. Historical experience indicates that the risk of default becomes around 5% once amounts are past due by 60 - 90 days and increases thereafter. Management estimates that a market rate for short-term, unsecured lending to this category of customer is 10%. None of the amounts are individually significant.

**Group 3 - receivables - small companies and individuals with limited credit histories**

Entity A has historically experienced high credit losses for this group at around 5% of invoiced amounts. Margins are however sufficient to support doing business with these customers. On average, customers in this category settle their debts in approximately 90 days of invoice. Historical experience indicates that the risk of default increases to around 10% once amounts are past due. Loss rates increase further as the number of days past due increases. Management estimates that a market rate for short-term, unsecured lending to this category of customer is 25% and the effect of discounting is considered material. None of the amounts are individually significant.

## Analysis

On the basis of these limited facts, the following table summarises how Entity A might design its processes for reviewing for and assessing impairment.

| | Group 1 | Group 2 | Group 3 |
|---|---|---|---|
| **Initial recognition** | Invoice amount (effect of discounting is immaterial) | Invoice amount (effect of discounting is immaterial) | Discounted amount, using a 25% discount rate over 90 days (discount of 5.7%, approximately equal to the expected level of credit loss at initial recognition) |
| **Items to be assessed individually** | All (since they are considered individually significant) | Items for which specific information is available and are found to be impaired<br><br>Items for which no specific information is available and items for which specific information is available but found not to be impaired (unlikely in practice) | As Group 2 |
| **Items to be assessed collectively** | All items assessed individually and found not to be impaired | **Individual** - evidence of financial difficulty, bankruptcy etc<br><br>**Collective** - receivables become overdue by 60 days or more (**note**: this is an example of defining an 'impairment trigger'. The effect of excluding amounts overdue by less than 60 days will be that some impairments are not recognised. This is acceptable if the effect immaterial). | As Group 2 |
| **Typical loss events (ie evidence of impairment)** | **Individual** - evidence of significant financial difficulty (eg poor trading performance, media articles indicating problems), filing for creditor protection, downgrade in credit ratings<br><br>**Collective** - general and significant deterioration in past due status | Based on percentages of amounts in each overdue age category beyond 60 days. These percentages should be derived from historical loss rates and reviewed based on future loss experience as it emerges.<br><br>No discount is applied to the expected cash flows since the effect is considered immaterial. | **Individual** - evidence of bankruptcy, unemployment, disappearance etc<br><br>**Collective** - receivables becoming overdue (**note**: although a majority of customers pay beyond the due date, late payment is acceptable evidence of impairment if it correlates with historical loss experience). |
| **Assessment methodology** | **Individual** - impairment recognised if the most likely outcome is that less than 100% will be received, based on specific facts<br><br>**Collective** - a largely judgmental assessment would be required in view of lack of history. The collective assessment may not need to be a detailed exercise given the low risk and individual review | | Based on set percentages of amounts in each overdue age category. These percentages should be derived from historical loss rates and reviewed based on future loss experience as it emerges.<br><br>A discount is applied based on the original EIR and the revised estimated of period to receipt. |

If you have further enquiries, do not hesitate to contact your usual point of contact at our offices.


**KUALA LUMPUR**

Level 11, Sheraton Imperial Court
Jalan Sultan Ismail
50774 Kuala Lumpur

T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

**PENANG**

51-8-A,
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang

T +604 228 7828
F +604 227 9828
E info.pg@my.gt.com

**KUANTAN**

A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang

T +609 515 6124
F +609 515 6126
E info.ktn@my.gt.com

**JOHOR BAHRU**

Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor

T +607 223 1848
F +607 224 9848
E info.jb@my.gt.com




**www.gt.com.my**