MFRS Hot Topics

Trade receivables and impairment (Part 1)

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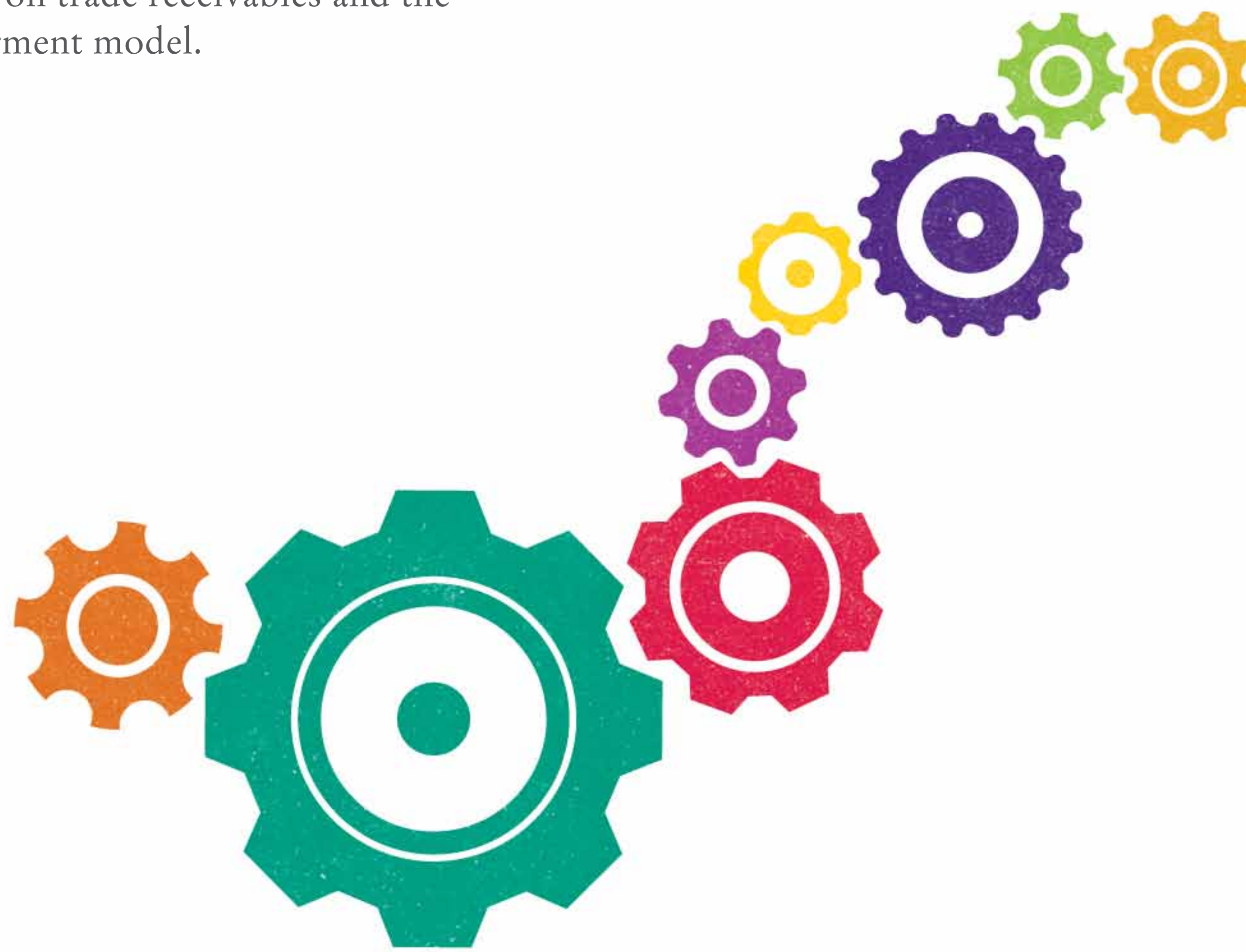
a publication from SJ Grant Thornton.
This issue reflects the requirements of MFRS 139 Financial Instruments: Recognition and Measurement on trade receivables and the related impairment model.



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

In Part 1 of this Hot Topics, we provide an introduction to the initial recognition of trade receivables, impairment model and accounting for bad debts under MFRS 139. Individual impairment assessment will be discussed in Part 1 while collective assessment will be discussed in Part 2, the next issue.

Contents

Introduction

Initial recognition

Trade receivables should be initially recognised at fair value (MFRS 139.43). The definition of fair value in MFRS 13 Fair Value Measurement emphasizes that fair value is a market-based measurement, not an entity-specific measurement. When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk (eg the credit risk in the receivables) (MFRS 13.3). However, short-term receivables with no stated interest rate are permitted to be recognised at invoice amount *if the effect of discounting is immaterial.*

MFRS 139 impairment model

At each reporting date, receivables should be reviewed for any objective evidence of impairment. Objective evidence of impairment might include:

- information indicating that the debtor is in significant financial difficulty (MFRS 139.59(a))
- breach of contract eg a debtor not paying by the due date (MFRS 139.59(b))
- information indicating that it is probable the debtor will become bankrupt or similar (MFRS 139.59(c))
- downgrade in credit rating (in conjunction with other information) (MFRS 139.60).

In practice, failure to pay by the due date will usually be the most common and easily identified indicator.

When evidence of impairment is identified, the amount of impairment is the difference between

(i) the carrying value of the receivables; and

(ii) the present value of the expected future cash flows discounted at the original effective interest rate (EIR) (MFRS 139.63).

MFRS 139.64 always requires *collective* or *portfolio* approach to impairment assessment. Further:

- an initial, individual review is required for items that are individually significant (MFRS 139.64)
- in the collective assessment, items are grouped on the basis of *common credit risk characteristics* (MFRS 139.AG87) items are removed from the collective assessment once information becomes available that specifically identifies losses on individual items (MFRS 139.AG88)
- any individual items that are reviewed and found not to be impaired are then also included in the collective assessment (MFRS 139.64).

Bad debts

Most businesses incur credit losses (bad debts) from time to time. The extent of credit losses varies widely depending (for example) on the credit standing of customers and entity-specific credit control practices.

MFRS 139 deals with credit losses through its requirements on impairment. Its approach is often referred to as an 'incurred loss' model. Under this approach impairments are recognised only on the basis of one or more 'loss events' that have occurred after the initial recognition. Loss events are also referred to as objective evidence of impairment. An event is a loss event if there is a correlation between the event and deterioration in the expected cash flows (amount and/or timing) from the receivables.

Some entities reporting under relevant local generally accepted accounting practices have (before applying MFRS) adopted accounting policies that are not necessarily supported by objective evidence such as:

- establishing general bad debt reserves to 'cover' the risk of possible future bad debts
- alternatively, or in addition, determining bad debt reserves using a 'provision matrix' that specifies provision percentages based on the length of time receivables are overdue.

These practices are or may be inconsistent with MFRS 139.

Although MFRS 139's impairment model can appear complex, the degree of sophistication required in practice should reflect the significance of credit losses to an entity's business. For most commercial businesses, implementing procedures to comply with the impairment requirements should not prove unduly burdensome. However, some analysis might be required to compile and maintain the necessary data on credit loss experience.

Bad debts and initial recognition

The MFRS 139 impairment model must be considered in conjunction with MFRS 139's requirements on initial recognition. When an entity recognises receivables at fair value, the risk of credit losses is wholly or partly reflected in the initial carrying amount. This results from using a discount rate that reflects the credit quality of the instrument (MFRS 13.B13-14). If an entity's customers present a high level of credit risk the discount rate reflects this.

However, many entities do not discount short-term receivables (with no stated interest rate) if the effect of discounting is immaterial. Under this approach, expected credit losses are not reflected in the initial carrying value. The effect of discounting should however be assessed:

- based on the expected payment period (rather than the stated credit period)
- using a discount rate that reflects credit risk.

Although the IASB deleted the explicit language in IAS 139.AG79 upon issuing IFRS 13, the Board has since proposed an annual improvement to clarify that it did not intend to change practice in the measurement of short-term receivables and payables.

MFRS 139 does not permit an immediate impairment loss to be recorded on initial recognition. Also, the definition of the amortised cost/effective interest method states that future credit losses are not considered in estimating future cash flows (MFRS 139.9). As a result of these requirements, it can appear that trade receivables are over-stated under MFRS 139. This is because (i) on a portfolio basis, it may be probable that some credit losses will be incurred but (ii) in the absence of specific evidence of impairment, the receivables may be stated at invoice amounts. However this effect (if it exists at all) should not be significant. This is because:

- the effect of discounting on initial recognition is likely to be material for entities that incur very high levels of credit losses
- as soon as a receivable becomes past due, there is or may be evidence of impairment
- the collective impairment assessment of past due amounts reflects the expected cash flows from the portfolio.

Impairment assessment

Impairment assessment

MFRS 139 sets out a two-step approach to impairment. This involves:

- reviewing the receivables for any objective evidence of impairment. This review must be carried out at each reporting date (MFRS 139.58)
- where such evidence exists, determining the amount of the impairment. For receivables reported at amortised cost, impairments are determined as the difference between
  - (i) the carrying value of the receivables; and
  - (ii)the present value of the estimated future cash flows discounted at the original effective interest rate (EIR) (MFRS 139.63).

The most common type of evidence of impairment of trade receivables are set out in the Introduction section. Further possible indicators are included at MFRS 139.59. Either a single or a combination of factors might cause impairment.

Consistent with the requirements on initial recognition, impaired short term receivables are not discounted if the effect is immaterial (MFRS 139.AG84). In some cases, the effect of discounting might have been immaterial on initial recognition but become material because of a deterioration in the expected timing of the future cash flows. In these cases the EIR should be estimated based on a market rate for the original receivable at initial recognition.

Individual assessment

MFRS 139 requires separate assessment of any items that are individually significant (MFRS 139.64). An entity should also carry out a separate assessment of any items for which it has specific information (MFRS 139.AG88). For example, an entity might receive notification that a customer has applied for protection from its creditors. This receivable should be assessed for impairment individually.

Eventually, specific information should become available for every impaired receivable. As a practical matter, entities might decide to treat very old balances that are no longer being pursued for payment as 'de facto' forgiven. These amounts are then de-recognised (ie written off).

When receivables are reviewed for impairment individually, the impairment loss (if any) is determined on a best estimate basis (MFRS 139. AG86). In the context of a single item, the best estimate is usually the most likely outcome.

In practice, the most likely outcome for an individual trade receivable is either that it will be paid in full or not at all.

Illustration 1

An entity has made a substantial sale to a large company and recorded a receivable of CU1m. The amount is due within 30 days. CU1m is individually significant to the entity. In accordance with MFRS 13, the receivable is recorded at the invoice amount (management estimates the market rate of interest for short-term, unsecured lending to this customer is 6%. The effect of discounting at 6% for 30 days is considered immaterial). At the year-end, the customer has not paid and the balance is 60 days past due. Management estimates that there is now a 95% probability that the amount due will be collected and a 5% risk of default. It further estimates that it will collect the outstanding amount (if paid) within 30 days.

The fact that the receivable is 60 days past due is an indicator of impairment. However, management still expects to receive 100% of the amount due based on the most likely outcome. Moreover, the effect of discounting remains immaterial. The receivable is not therefore considered impaired at the individual level, but is included in the collective assessment.

In the next MFRS Hot Topics, the publication will cover the second part of the topic of trade receivables and impairment. The collective assessment will be discussed and also the reversal of impairment losses, credit losses and dispute risks. A flow chart for impairment review of portfolio trade receivables will also be available.

Topics covered in the next February 2014 issue:

- impairment assessment: collective assessment
- reversal of impairment losses
- credit losses and dispute risk
- flow chart for impairment review of portfolio of trade receivables

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