Financial Reporting Council

Accounting and Reporting Policy
FRS 102

Staff Education Note 3
Impairment of trade debtors

Contents

Introduction

This Staff Education Note provides information on the requirements for the impairment of financial assets measured at cost or amortised cost, specifically on the impairment of trade debtors, and is written for entities that do not currently apply FRS 26 (IAS 39) *Financial instruments: recognition and measurement*.

Both current UK accounting standards and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* require financial assets to be carried at the lower of their carrying amount or recoverable amount. A financial asset is therefore impaired when there is a reduction in its recoverable amount below its carrying amount. However there are differences in the level of guidance provided for identifying and measuring impairments.

Please note that the FRC intends to issue a supplementary exposure draft as the IASB finalises the requirements of IFRS 9 *Financial Instruments*. The supplementary exposure draft will propose changes to Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*. Therefore, paragraphs 11.21 to 11.24 of FRS 102 referred to below may be subject to change.

This Staff Education Note is written to highlight key areas of consideration when transitioning to FRS 102 and is not designed to be exhaustive.

Impairment requirements of financial assets measured at cost or amortised cost

Current UK accounting standards

There is a general requirement in company law that current assets must not be stated at more than their net realisable value. For those entities not applying FRS 26 there is little detail in current UK accounting standards on impairment of current financial assets (as opposed to fixed assets and goodwill, which are covered by FRS 11 *Impairment of fixed assets and goodwill*).

FRS 102

FRS 102 is more prescriptive, including an explicit requirement for there to be objective evidence of an impairment, which may lead to some changes in practice.

For most entities that are not financial institutions, the main financial assets that will be subject to possible impairment are trade debtors (receivables). Most entities are already likely to be making a 'bad debt provision', but they will need to ensure that their processes are consistent with the requirements of FRS 102. Application of FRS 102 will not necessarily result in a significant change in the carrying amount of trade debtors.

Extract from FRS 102

*11.21 At the end of each reporting period, an entity shall assess whether there is objective evidence of impairment of any financial assets that are measured at cost or amortised cost. If there is objective evidence of impairment, the entity shall recognise an **impairment loss** in profit or loss immediately.*

11.22 Objective evidence that a financial asset or group of assets is impaired includes observable data that come to the attention of the holder of the asset about the following loss events:

(a) significant financial difficulty of the issuer or obligor;

(b) a breach of contract, such as a default or delinquency in interest or principal payments;

(c) the creditor, for economic or legal reasons relating to the debtor's financial difficulty, granting to the debtor a concession that the creditor would not otherwise consider;

*(d) it has become **probable** that the debtor will enter bankruptcy or other financial reorganisation; and*

(e) observable data indicating that there has been a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, even though the decrease cannot yet be identified with the individual financial assets in the group, such as adverse national or local economic conditions or adverse changes in industry conditions.

11.23 *Other factors may also be evidence of impairment, including significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates.*

11.24 *An entity shall assess the following financial assets individually for impairment:*

(a) *all equity instruments regardless of significance; and*

(b) *other financial assets that are individually significant.*

An entity shall assess other financial assets for impairment either individually or grouped on the basis of similar ***credit risk*** *characteristics.*

Impairment of trade debtors

Objective evidence

Under FRS 102, to recognise an impairment loss there must be objective evidence that the loss has occurred (ie there will be an impact on the expected future cash flows associated with the debtor), and that this is a result of one or more past events. Losses expected to arise as a result of future events may not be recognised. Paragraph 11.22 sets out examples of observable data that might be considered as objective evidence that a loss has occurred (eg the death of a debtor).

In the absence of any objective evidence or observable data indicating that a loss has occurred, there is no basis for recognising an impairment, or bad debt provision.

Individual financial assets

An entity needs to assess financial assets for impairment individually in the following circumstances:

a) Where the entity does not routinely provide credit, either at all, or to certain types of debtor, the entity should consider whether those assets should be part of a group of assets with similar credit characteristics, and if not they must be assessed for impairment individually;

b) Where the financial asset is individually significant; or

c) Where there is specific information about the credit risk of that financial asset (regardless of whether or not it is part of a group of financial assets with similar credit characteristics).

A group of financial assets

Paragraph 11.22(e) states that where observable data indicates that there has been a measureable decrease in the estimated future cash flows from a group of financial assets, even though the decrease cannot yet be identified on an individual asset basis, this is objective evidence that an impairment has occurred.

To apply this in practice, it may be necessary to identify groups of debtors within the overall portfolio that have similar credit risk characteristics (eg trade debtors with the same geographical location or industry sector or demographic) and then estimate the loss that is expected from that group. It is reasonable to make use of historical loss experience as a basis for this estimate, but it should be adjusted to:

a) reflect the effect of current conditions that did not affect the period on which the historical loss experience is based; and

b) remove the effects of conditions in the historical period that do not exist currently.

It may not be sufficient to only use days past due to calculate bad debt provisions (ie impairment losses on trade debtors). It is likely that the debtors will need to be stratified by more than just days past due, in order to reflect other credit risk characteristics, and the formula needs to reflect actual experience of delinquency, which is expected to continue. Such formulae would need to be kept under active review, and reflect changes in credit risk characteristics, such as a change in the customer base, not just historical loss experience.

Example

A furniture retailer which has a small chain of stores, offers extended credit terms for purchases over £2,000. In the vicinity of one store, a significant local employer announces redundancies amounting to approximately 20% of its staff. The manager of this store estimates that 40% of its debtors are currently employed by this employer, and therefore it might be expected that 8% (20% of 40%) of the debtors may lose their jobs.

Using observable data about the likely extent of default to measure the amount of the impairment (for example, historical evidence from a previous period of higher unemployment), the furniture retailer should estimate and recognise an impairment loss for the group of financial assets relating to the people employed by this particular local employer.

If there is observable data that job losses at this employer have a knock-on effect on the local economy as a whole, the impact should be considered separately. The furniture retailer should not apply this impairment to all debtors as they do not share the same credit risk characteristics of this sub-group.