



GRAP 104 on *Financial Instruments* (Revised)



Your guide to understanding and applying the revised Standard

This article is part of a series of articles that discuss the key amendments to GRAP 104 (revised). GRAP 104 is the authoritative source. Other supplementary resources are intended to be read alongside GRAP 104 and do not replace or override its guidance. The article has been prepared by the Secretariat of the ASB for information purposes only. It has not been reviewed, approved, or otherwise acted on by the Board.

GRAP 104 (revised) impairment simplified

One of the most significant changes in the revised GRAP 104 on *Financial Instruments* is the new impairment model for financial assets at amortised cost. The change aims to address the shortcomings in the measurement of financial assets highlighted during the financial crisis, as explained below.

The current impairment model focuses on losses that are incurred and considers historical information. The new model is based on expected credit losses (ECL) and assesses the risk of potential default, based on past, current and future expectations. The reason for the change is that the current information about impairment losses does not allow for timely action and decision making because information is only available when the losses occur. The new model allows for more timely decision making as it provides predictive information.

The new model is a 2-step approach illustrated below. This applies to financial assets that are not purchased or originated credit-impaired.

Step 1: Determine the period over which the ECL is calculated

- Has there been a significant increase in the credit risk of the financial asset since initial recognition?
- Significant increase → period = lifetime
- No significant increase → period = 12 months

Step 2: Determine the ECL

- Present value of the difference between the cash flows due under the contract and the cash flows expected to be received.

Step 1:

At each reporting date, an entity assesses whether there has been a significant increase in the credit risk of a financial asset since it was initially recognised. A significant increase in credit risk is assessed with reference to an increase in the risk of default occurring over the expected life of the financial asset. GRAP 104 provides indicators that are useful in assessing changes in credit risk. For example, an entity holds an investment measured at amortised cost. Market expectations indicate that an external credit rating downgrade on the investment is imminent. This increases the risk of default by the investment provider. The entity assesses this as a significant increase in credit risk of the investment.

There is a rebuttable presumption that the credit risk of a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

If there has been a significant increase in credit risk, the period over which the ECL is calculated is over the contractual lifetime of the asset. If the credit risk has not increased significantly since initial recognition, the period over which the ECL is calculated is 12 months from the reporting date.

GRAP 104 allows for a simplified approach for receivables and lease receivables. Under the simplified approach, the change in credit risk need not be assessed. The period over which the ECL is calculated is over the lifetime of the receivable.

Step 2:

The ECL is calculated as the present value of the difference between the cash flows due under the contract and the cash flows that the entity expects to receive. It is discounted using the effective interest rate. The ECL should reflect a probability-weighted amount that is determined by evaluating a range of possible outcomes. For example, an entity determines that due to an increase in interest rates, a debtor may not be able to settle his account in full. The entity identifies three possible outcomes, being:

1. The debtor pays in full and on time;
2. The debtor cannot pay 45% of his total debt but pays 55% on time; and
3. The debtor cannot pay 90% of his total debt but pays 10% on time.

The entity assesses how probable each of the outcomes are and assigns a probability rate to each outcome. The ECL is the sum of the probability-weighted amount of each outcome.