

Ind AS 109 and ECL Modeling Key Judgments and Practical Challenges

Expected Credit Loss (ECL) under Ind AS 109 sits at the intersection of accounting, credit risk assessment, and professional judgment. Its forward-looking framework requires entities to apply models, staging criteria, and macroeconomic assumptions that can significantly influence reported profits, net worth, and key ratios. As a result, ECL outcomes can vary materially based on how these judgments are made and supported. This article examines the practical realities of ECL modeling, highlighting key judgment areas and common challenges that matter for both preparers and those evaluating the reasonableness of ECL estimates.

Expected Credit Loss

Expected Credit Loss (ECL) represents a probability-weighted estimate of credit losses over the expected life of a financial instrument, measured as the present value of cash shortfalls. In simple terms, it reflects the weighted average of possible credit loss outcomes, with the likelihood of default driving the weighting.

Amounts due

-

Amounts expected to be received

=

Cash Short Fall

Application to Financial Instruments

The following tables illustrate the applicability and inapplicability of ECL to various financial instruments.

| ECL Applies | ECL does not apply |
|--|--|
| Trade Receivables | Derivatives |
| Loans | Investments in |
| Loan commitments | Equity Instruments |
| Financial Guarantee contracts | (including investments in |
| Lease Receivables | Subsidiary, Associate, |
| Debt instruments measured through | joint venture). However, the |
| <ul style="list-style-type: none"> Amortized cost FVTOCI | equity investments in subsidiaries, associates and joint ventures which are carried at cost are to be tested for impairment as per the provisions of Ind AS 36 which requires a comparison of carrying amount with the recoverable amount. |

When to Apply

Entities are required to measure lifetime expected credit losses when the **credit risk** of financial instruments increases significantly from initial recognition.

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

- For loan commitments and financial guarantee contracts, the date on which the entity becomes a party to an irrevocable commitment is the date of initial recognition for this purpose.

How to Measure

Increase in Credit Risk

Compare the default risk on the reporting date with the default risk on the date of initial recognition.

The expected life of a financial instrument affects its default risk. Instruments with a longer remaining life generally carry a higher default risk. As maturity approaches and credit risk remains unchanged, the default risk typically declines, except where substantial payment obligations fall due near maturity.

There are rebuttable presumptions that,

- The credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

- A financial asset is in default no later than when it becomes 90 days past due, unless the entity has reasonable and supportable evidence that a later default point is more appropriate. Deemed default at 90 days past dues (DPD).
- **Low credit risk instruments** - Credit risk on a financial asset is assumed to be low if:
 - Financial assets have low default risk
 - The borrower has a strong capacity to meet its obligations
 - Adverse economic and business conditions will not reduce the ability to fulfill the obligation.

Expected Credit Loss

| Stage 1: Performing Assets | Stage 2: Underperforming Assets | Stage 3: Credit-Impaired Assets (Non-Performing) |
|--|---|--|
| Credit risk has not changed significantly since initial recognition (or) Low Credit Risk Asset | Significant increase in credit risk since initial recognition | Objective Evidence of Impairment at the reporting date |
| ECL = 12 Month ECL[^] | ECL = Lifetime ECL^{^^} | ECL = Lifetime ECL |

[^] 12-month ECL = Lifetime cash shortfall × probability of default in the next 12 months

^{^^} Lifetime ECL: The expected credit losses that result from all possible default events over the expected life of a financial instrument.

Example: If a loan of INR 1 million would result in a loss of INR 0.5 million on default and the probability of default in the next 12 months is 2%, the 12-month ECL would be INR 10,000. This does not imply that the entity expects to lose INR 10,000 in the next year; rather, it represents the probability-weighted cost of the risk that a default may occur in the next 12 months.

Requisite Characteristics of ECL

Usage of Reliable and Supportive information which is reasonably available at the reporting date without undue cost or effort, including information about past events, current conditions, and forecasts of future economic conditions.

Forward-looking: When forward-looking information is available without undue cost & effort, reliance cannot be solely placed on past information. The entity should also consider observable market information about

the credit risk of the financial instrument or similar financial instruments.

Sources of information (non-exhaustive list) could be -

- Internal Credit ratings
- Entity’s historical credit loss experience
- External Ratings
- Liquidity situation of the counterparty
- Macroeconomic factors such as interest rate changes, regulatory changes, and other business conditions.

Probability weighted: An estimate of expected credit losses shall always reflect the possibility that a credit loss occurs, and the possibility that no credit loss occurs even if the most likely outcome is no credit loss.

Time value of money: ECL should be discounted to the reporting date using the effective interest rate determined at the date of initial recognition. A credit loss arises even if the entity expects to be paid in full but later than when contractually due.

Given the extent of judgment required to apply these characteristics, the ECL model represents a significant area of estimation uncertainty and audit focus.

Assessment of ECL as 'Significant Risk' by Auditors

In the auditor's assessment of the risk of material misstatement, a risk is considered significant when it involves heightened judgment, estimation uncertainty, or complexity, with the potential to materially affect the financial statements.

Expected Credit Losses often meet this threshold, given the reliance on complex

models, forward-looking assumptions, and management judgment. This risk is particularly pronounced in credit-driven businesses such as banks, NBFCs, and other lending entities, as well as in high-volume trade credit environments (including FMCG and manufacturing) and business models characterized by long-term receivables, such as real estate, leasing, and infrastructure.

Key Drivers of the Assessment as a Significant Risk

- Extensive use of estimates and assumptions, including the probability of default and loss given default
- Complexity in calculations
- Judgment is involved in accounting policy elections, such as the choice between the General and Simplified Approach, and in the treatment of specific transactions, such as Financial Guarantee Contracts and Loan Commitments
- Specific and extensive disclosure requirements require entities to explain key assumptions, estimation uncertainty, and credit risk exposures

Key Financial Statement Assertions for ECL

While auditing Expected Credit Loss, auditors focus on a set of key assertions. The table below summarises illustrative areas of focus and the risks typically associated with them.

| Assertion | Focus Area | Where the Risk Typically Arises |
|----------------|--|--|
| Valuation | Whether expected credit losses are measured in accordance with Ind AS 109 and appropriately reflect the entity's exposure to credit risk | <ul style="list-style-type: none"> • Inappropriate staging between Stage 1 and Stage 2 • Incorrect application of 12-month versus lifetime ECL • Use of assumptions or management overlays that materially affect the estimate. |
| Completeness | Whether all financial instruments subject to ECL requirements have been identified and included in the impairment assessment | Exclusion of inter-company balances, security deposits, loan commitments, financial guarantee contracts, or lease receivables |
| Accuracy | Whether data and calculations used in determining ECL are complete, accurate, and derived from reliable source systems. | Errors in aging, days-past-due computation, or incorrect linkage of source data to ECL models |
| Classification | Whether financial assets are appropriately classified and segregated for the purpose of applying the ECL model | Incorrect segregation between originated credit-impaired assets and regular receivables, or between trade receivables, loans, and lease receivables |
| Disclosure | Whether disclosures adequately describe the basis of estimation, key assumptions, estimation uncertainty, and credit risk exposure | Omission of key assumptions or sensitivities, inadequate explanation of staging movements, and management overlays |



ECL – Areas Requiring Heightened Audit Attention

Below are some of the aspects that would require additional audit efforts or attention:

- Consider whether Expected Credit Loss has been appropriately identified as a significant risk, considering the level of estimation uncertainty and judgment involved (SA 315, SA 330)
- Apply professional skepticism in evaluating staging decisions, particularly in assessing a significant increase in credit risk beyond contractual delinquency indicators (SA 315, SA 540)
- Evaluate the robustness and sensitivity of key assumptions and forward-looking inputs, recognizing that minor changes may have a material impact on ECL outcomes (SA 540)
- Where management overlays are applied, assess whether such adjustments are evidence-based, unbiased, consistently applied, and supported by appropriate governance (SA 540)
- Consider whether accounting policy elections under Ind AS 109 are applied consistently and in accordance with eligibility criteria, rather than being outcome-driven (SA 315)
- Evaluate whether disclosures clearly explain key judgments and estimation uncertainty, rather than merely restating accounting policy requirements (SA 540, SA 700)
- Consider whether Expected Credit Loss represents a matter of most significance requiring communication as a Key Audit Matter, where applicable (SA 701)
- Analyze current default rates and aging patterns with historical trends to identify inconsistencies in credit risk behavior (SA 540)

Conclusion

Expected Credit Loss under Ind AS 109 is ultimately shaped by the quality of judgments applied across models, staging, assumptions, and overlays rather than by the mechanics of computation alone. The credibility of the ECL estimate, therefore, depends on how well these judgments are supported by data, aligned with underlying credit risk, and transparently explained in the financial statements. A disciplined focus on these areas is essential to ensure that ECL outcomes are not only technically compliant but also faithfully represent the entity's credit risk profile.

Illustrations

The section below provides some specific illustrations of the ECL working and the points to be considered by Auditors.

Illustration 1

An entity has a trade receivables portfolio of INR 100 million outstanding at the reporting date. At initial recognition, the portfolio's probability of default (PD) was assessed at 1%.

During the current year, aging trends indicate deterioration, with a significant portion of receivables now 31 to 60 days past due. Based on updated credit information, the lifetime PD is reassessed at 6%.

Management continues to classify the receivables under **Stage 1** on the basis that no contractual defaults have occurred and historical losses remain low. Accordingly, a **12-month ECL** is recognized based on a 12-month PD of 2%, resulting in an impairment of INR 2 million.

If the receivables were classified under **Stage 2** due to a significant increase in credit risk, **lifetime ECL** would apply. Assuming an expected loss rate of 6% over the remaining life, the impairment would increase to INR 6 million.

Audit viewpoint

Evaluate whether the observed deterioration in aging and the increase in lifetime PD constitute a significant increase in credit risk.

Illustration 2

An entity grants a five-year loan of INR 5 million. In the event of default, the estimated loss is INR 2.5 million. Probability of default in the next 12 months: 1%. Probability of default over the remaining life of the loan: 8%.

Under Stage 1, the 12-month ECL is calculated as: INR 2.5 million × 1% = INR 25,000

Under Stage 2, the lifetime ECL would be: INR 2.5 million × 8% = INR 0.2 million

Although the likelihood of default over the next 12 months is low, the lifetime default risk is significantly higher, leading to a materially different impairment outcome.

Audit viewpoint

Evaluate whether the continued application of 12-month ECL is appropriate, considering changes in credit risk since initial recognition.

Assessing whether the increase in lifetime default risk warrants recognition of lifetime ECL.

Illustration 3

An entity recognizes Expected Credit Loss of INR 12 million on its trade receivables as at the reporting date. The ECL estimate is based on a probability-weighted model incorporating three macroeconomic scenarios:

| Scenario | Probability | Expected Credit Loss |
|-----------|-------------|----------------------|
| Base case | 50% | INR 10 million |
| Downside | 30% | INR 15 million |
| Upside | 20% | INR 8 million |

The probability-weighted ECL aggregates to INR 12 million. The financial statements disclose the total ECL recognized but do not disclose the existence of multiple scenarios, the probability weightings applied, or the sensitivity of the estimate to changes in assumptions.

If the probability assigned to the downside scenario were increased from 30% to 45%, the ECL would increase to approximately INR 13.3 million, representing a sensitivity of INR 13 million.

Audit viewpoint

Auditors often audit the numbers but miss the story behind them. The absence of disclosure regarding scenario assumptions and sensitivity limits users' ability to understand the estimation uncertainty inherent in the ECL model. The audit focus, therefore, extends beyond the measurement of ECL to evaluating whether disclosures adequately explain the key judgments and the potential variability of outcomes



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