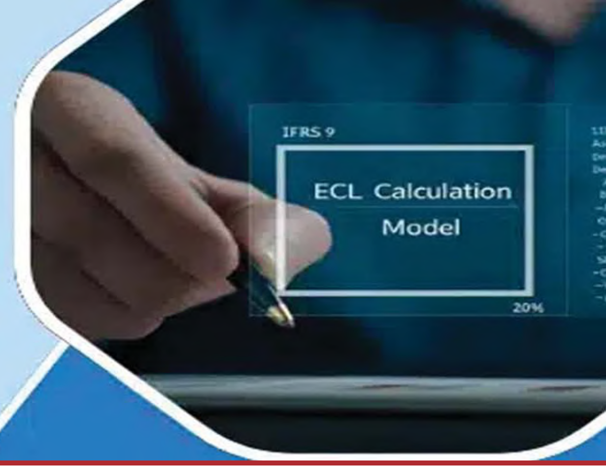
Expected Credit Loss (ECL) A Complete Conceptual and Practical Guide



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Introduction

Expected Credit Loss (ECL) is a forward-looking impairment model introduced in International Financial Reporting Standard 9 – Financial Instruments, replacing International Accounting Standard 39. Expected Credit Loss represents the amount an entity expects to lose on its financial assets—such as receivables, loans, and advances even before an actual default occurs. This approach significantly increases financial stability, credit risk assessment and transparency.

Definition of ECL

ECL is the estimated loss that an entity expects to incur because a customer or counterparty may:

- pay late,
- pay partially, or
- fail to pay entirely.

ECL incorporates:

- Future expectations of risk,
- Probability of default (PD),
- Expected timing of cash flows, and
- Time value of money (discounting).

This makes ECL a more realistic measure of financial risk compared to the old incurred-loss approach.

Global Implementation of ECL Under IFRS 9

IFRS 9 became effective from January 1st, 2018 internationally. The standard addressed major weaknesses in IAS-39, particularly the recognition of credit losses only after a default event. IFRS 9 introduced the "expected loss" model to ensure that losses are recognized in a timely and forward-looking manner.

Implementation of ECL in Pakistan

Pakistan adopted IFRS 9 in phases:

1. **Banks and DFIs**
   - Enforced by State Bank of Pakistan (SBP)
   - IFRS 9 Circular No. 4 of 2022
   - Fully effective 1 January 2023
2. **Listed (Non-Banking) Companies**
   - SECP adopted IFRS 9 vide S.R.O. 116(I)/2020
   - Effective 1 July 2020

Therefore, all public companies in Pakistan must apply ECL to:

- Trade receivables
- Loans
- Advances
- Financial assets at amortized cost
- Certain investments

Calculation of Expected Credit Loss

Simplest Formula

Expected Credit Loss = PDx LGDx EAD

Where:

- **Probability of Default (PD):** Likelihood that a customer will not pay
- **Loss Given Default (LGD):** Percentage loss if default occurs
- **Exposure at Default (EAD):** Balance Outstanding

Step-by-Step ECL Process

Step 1: Assess Credit Risk

Initially, the credit risk should be evaluated to determine whether it has increased significantly since initial recognition. Indicators include:

- Payment delays beyond 30 days
- Internal or external credit rating downgrade
- Weakening financial position
- Negative macroeconomic trends

Step 2: Determine the Stage of the Asset

Under the IFRS-9 financial assets are divided into three stages:

Stage	Credit Quality	Measurement	Example
1	Credit Risk is low	ECL with 12 months	Payments are coming normally
2	Risk increased significantly	ECL – Lifetime	Payments delays > 30 days
3	Default / credit-impaired	ECL – Lifetime with high PD & LGD	Payments delays > 90 days

Stage 1 – 12-Month ECL

Expected Credit Loss = PD (stage 1) X LGD X EAD
(Low PD & LGD)

Stage 2 – Lifetime ECL

Expected Credit Loss = PD (stage 2) X LGD X EAD
(High PD & LGD)

Includes forward-looking economic adjustments.

Stage 3 – Credit Impaired

Expected Credit Loss = PD (stage 3) X LGD X EAD (discounted)

ECL = Carrying Amount — PV (Expected Cash Flows)

(High PD & LGD)

Includes forward-looking economic adjustments.

The rate of discount should be the effective interest rate.

Requirements:

- Cash flow forecasting
- Discounting
- Professional judgment

Simplified Approach for Trade Receivables

Used for customers and routine receivables.

Aging Method

1. Prepare an aging schedule
2. Assign loss rates to each bucket
3. Multiply balance × loss rate

Example

Aging	Balance	Loss Rate	ECL
0–30 days	2,000,000	1%	20,000
31–60 days	1,200,000	5%	60,000
61–90 days	800,000	10%	80,000
90+ days	500,000	50%	250,000
Total ECL			410,000

How Companies Determine PD, LGD, and Loss Rates

Factors include:

- Historical default data
- Customer behaviour patterns
- Market conditions (GDP, inflation, currency devaluation)
- Forward-looking macroeconomic assumptions
- Industry-specific risk experience

Conclusion

The Expected Credit Loss (ECL) model under IFRS 9 is a big improvement in how companies identify credit risk. Instead of waiting for a loss to happen, ECL uses a forward-looking method to estimate possible losses in advance. This makes financial statements more reliable and helps businesses manage risk better.

As companies apply this model, they need strong data, better risk-management processes, and good analysis tools. In the end, ECL is more than just an accounting rule—it helps organizations stay prepared, protect their financial health, and make better decisions in a changing economic environment.

About the Author: Syed Adnan Hussain Shah *is a seasoned finance professional with 22 years of vast industry experience. His expertise spans Financial Services, including Pensions and Asset Management, Microfinance and SME lending, and Insurance Services. He is an FCMA from the Institute of Cost & Management Accountants of Pakistan and holds an Advance Diploma in Management Accounting from CIMA.*