

# **GRAP RECEIVABLE IMPAIRMENT METHODOLOGY POLICY**



**MALUTI-A-PHOFUNG LOCAL MUNICIPALITY  
PROPOSED GRAP RECEIVABLE IMPAIRMENT METHODOLOGY POLICY**

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## **1. Purpose**

The purpose of this document is:

- To set out a methodology for the calculation of impairment of receivables in line with GRAP
- To ensure that an allowance for impairment is recognised for a receivable where there is objective evidence that it is impaired;
- To ensure the impairment allowance is measured as the difference between the receivables carrying amount and present value of future cash flows discounted at the effective interest rate, computed at initial recognition; and
- To ensure that receivables as disclosed in the annual financial statements are stated at values that are deemed collectible.

## **2. Scope**

The methodology is applicable to all receivables carried at amortised cost as per GRAP 104 requirements, excluding receivables with credit balances. This is due to these balances being reclassified as trade payables in the annual financial statements.

Receivables carried at amortised cost include the following line items as disclosed in the annual financial statements:

- Receivables from exchange transactions
- Receivables from non-exchange transactions

## **3. Definitions and abbreviations**

<b>AO</b>	Accounting Officer
<b>CFO</b>	Chief Financial Officer
<b>Financial year</b>	2017, 2018 ,2019 ,2020
<b>GRAP</b>	Generally Recognised Accounting Practice
<b>MFMA</b>	Municipal Finance Management Act
<b>Reporting date</b>	30 June 2019

#### **4. Applicable accounting standards**

GRAP 104 Financial Instruments sets out the requirements for the impairment of financial assets subsequently measured at amortised cost.

GRAP 104.46 *“All financial assets measured at amortised cost, or cost, are subject to an impairment review...”*

GRAP 104.57 *“An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraphs .61 to .63 (for financial assets carried at amortised cost) and paragraph .64 (for financial assets carried at cost) to determine the amount of any impairment loss. “*

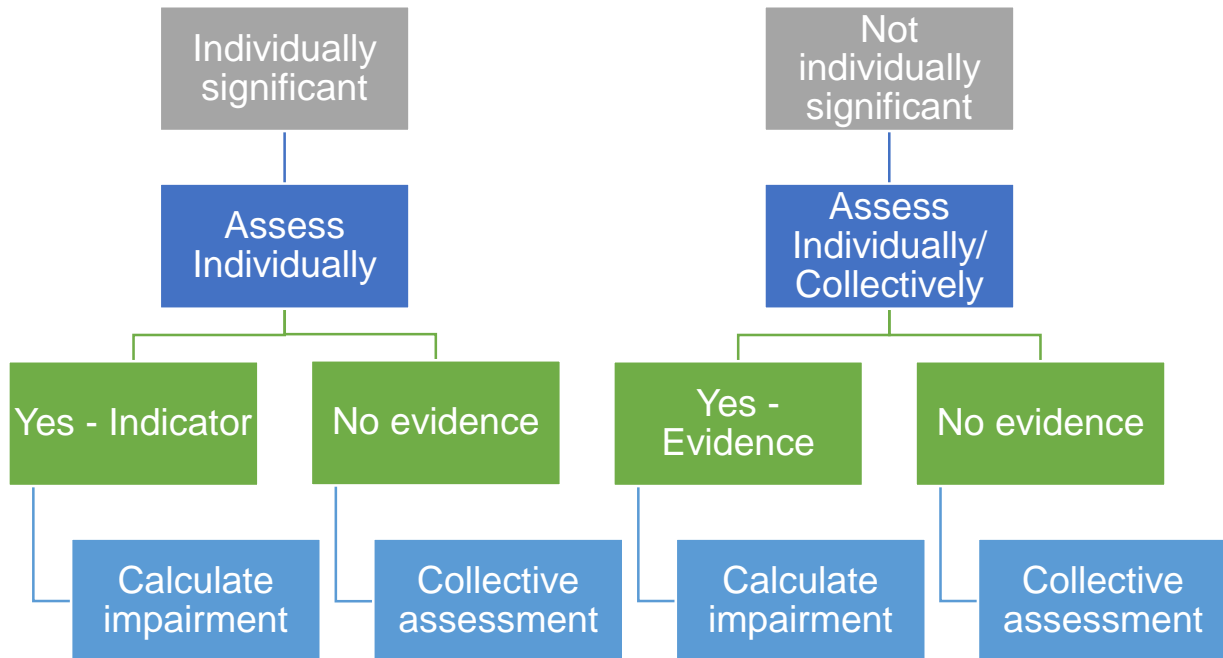
GRAP 104.58 *“A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a ‘loss event’) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.”*

GRAP 104.61 *“If there is objective evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset’s original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced through the use of an allowance account. The amount of the loss shall be recognised in surplus or deficit.”*

GRAP 104.62 *“An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph .58). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.”*

## 5. Methodology

### 5.1 Decision tree for GRAP 104 impairment



### 5.2 Assessment of impairment

Determine whether there is objective evidence of impairment for:

1. Individually significant receivables.
2. Individually or collectively for receivables not individually significant.

If an entity determines that no objective evidence of impairment exists for an individually assessed receivable, whether significant or not, it includes the receivable in a group of receivables with similar credit risk characteristics and collectively assesses them for impairment.

If there is objective evidence that a receivable is impaired and this receivable is individually assessed, the receivable is excluded from the collective assessment.

### **5.3 Identifying individually significant receivables**

#### **QUANTITATIVE INDICATORS**

The guidelines below provide us with a Rand value determination of whether a receivable is individually significant or not.

#### **MFMA:**

The following parameters (guidelines) for setting the rand value determination of materiality have been derived from the National Treasury Practice note on applications under section 54 of the Public Finance Management Act no. 1 of 1999 (as amended) ("PFMA") by public entities.

Basis	Acceptable percentage range
Total revenue	0.5% - 1%
Total assets	1% - 2%
Profit or surplus after tax (where relevant)	2% - 5%

In line with the above guidance from National Treasury a decision has been made to use the median of the total revenue being 0.75%.

Due to lack of authoritative guidance the above National Treasury guidelines will be followed. Therefore the 0.75% of total revenue will be used for the assessment.

#### **QUALITATIVE INDICATORS**

These are examples of other factors to take into consideration to determine whether a receivable should be classified as individually significant.

- Are there important receivables which at reporting date do not have significant balances as defined above?
- Are there any receivables that are vital to the continuation of the entity from a cash flow perspective?
- Are there any receivables experiencing significant financial or operation difficulties (this can be based on newspaper articles, word of mouth, past experience, etc.)?
- Are there related party receivables?

#### **5.4 Determination whether objective evidence of impairment exists**

Objective evidence of impairment exists when the following loss events are present:

- (a) significant financial difficulty of the receivable;
- (b) a breach of contract, such as a default in payment of interest or principal payments;
- (c) the entity, for economic or legal reasons relating to the receivables' financial difficulty, granting to the receiver a concession that the entity would not otherwise consider ( such as extended payment terms, discount, etc); or
- (d) it is probable that the receivable will enter sequestration or other financial reorganisation.

#### **5.5 Individual or collective assessment for impairment**

As noted above receivables are assessed individually if they are significant otherwise they are assessed either individually or collectively. For the purposes of collective assessment of impairment, receivables are grouped based on similar credit risk characteristics. This grouping is done based on a credit risk evaluation or grading process that considers:

- Asset type;
- Industry;
- Geographical location;
- Collateral type;
- Past due status; and
- Other relevant factors.

Should it occur that a receivable does not fall into one of the risk categories as defined, the receivable will need to be individually assessed.

Should objective evidence of impairment become available on an individually significant receivable that has been grouped into the risk categories, this receivable should be removed from the collective assessment and assessed individually as required.

The proposed categories represent our proposed risk categories into which the receivables should be classified for the impairment assessment.

#### **Proposed categories:**

- National government
- Provincial government (including school)

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- Local government
- Businesses
- Individuals per ward
- Non-profit organisations (including churches and other NPO's)
- Farms
- Long term receivables (greater than 12 months)

**When classifying entities into the proposed categories, the nature of the business should be taken into account and not legal form.**

**Also remember each receivable can only fall into a single category, it can't be duplicated.**

Once these risk categories have been determined, an assessment should be made whether the group has any objective evidence of impairment as noted above.

## **5.6 Impairment calculation**

The amount of the loss is measured as the difference between the receivable's carrying value and the present value of estimated future cash flows, discounted at the receivable's original effective interest rate.

The impairment will be recognised by way of an allowance account.

### **5.6.1 Estimated future cash flows**

Future estimated cash flows are estimated by reference to the historical loss experience for receivables with similar credit risk characteristics.

To determine the historical loss experience take into account one year historical data (current year) as this will give the most relevant information relating to the actual losses experienced. This is due to the fact that receivables are deemed to be of a short term nature – i.e. less than 12 months

The determination of the future expected cash flows for the impairment calculation will be based on the historical loss data of the receivable account for the past year. In order to determine the average payment percentage expected from the receivable, the billing for the past year will be totalled and divided by the total payments received for the period.



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The expected future cash flow is then determined as the amount subject to impairment times the expected recovery percentage.



### 5.6.2 Effective interest rate

The original effective interest rate cannot be used due to the balance of the receivables account representing a series of individual transactions throughout the period. As a practical expedient the R208 government bond rate (redemption date 2021) of 6.75% is used as the risk free rate. This is in line with GRAP 104 Financial Instruments Application Guidance par AG85.

#### MFMA proposed categories:

Entity	Adjustment from risk free rate	Effective interest rate
National government	+3.25%	10.00%*
Provincial government	+3.25%	10.00%*
Local government	+3.25%	10.00%*
Businesses <sup>1</sup>	+3.75%	10.50%

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Non-profit organisations <sup>1</sup>	+4.25%	11.00%
Farms <sup>1</sup>	+4.75%	11.50%
Individuals per ward <sup>1/2</sup>	+4.75% to 6.75%	11.50% to 13.50%
Long term receivables <sup>1</sup>	5.25%	12.00%

\* This rate is gazetted in Gazette 41593 dd 26 April 2018 as the effective interest rate for debts owing to the state.

<sup>1</sup> All other non-government entities have a base rate adjustment of 3.25% based on the fact that if they were government debtors, the minimum prescribed rate is 10.00% as noted above.

As the risk increases, an adjustment of 0.50% per increase in risk is made. This is a generic adjustment, and should be amended based on discussions with management.

The above are listed in sequence as the risk increases.

<sup>2</sup> The range for individuals depend on the different risk categories identified within individuals, be it income categories, payment history, wards, etc.

### 5.6.3 Expected repayment term

Using the receivables ledger, an average repayment term will be calculated per receivables grouping which has objective evidence that it is impaired. This is calculated as the average balance of the grouping for the reporting period divided by the billing to the receivables account for the year times 365 days. This will include interest charges levied.



### 5.6.4 Calculation of impairment loss

The present value of the future cash flows is determined using the present value formula in MSExcel.

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**Sources**

Accounting Standards Board, “GRAP 104 Financial Instruments”, 1 April 2018

Accounting Standards Board, “GRAP 104 Financial Instruments Application Guidance”, 1 April 2018

Current market rates – South African Reserve Bank, <https://www.resbank.co.za>, 11 March 2019

Standard interest rates to be levied on debts owing to the state, <http://www.treasury.gov.za/legislation/pfma/interest%20rates/20%20Standard%20interest%20rates%20on%20debts%20owing%20to%20the%20State%20-%20effective%201%20May%202018.pdf>, 11 March 2019