



# Expected Credit Loss

## Bridging the Gap Between Theory and Business Impact

Expected Credit Loss (ECL) is one of the most judgement-driven areas of financial reporting. For lenders, corporates and investors alike, the impairment allowance directly affects profit, equity, regulatory capital and covenant headroom - often with a level of volatility that can be difficult to explain.

The standard requires a forward-looking, probability-weighted assessment of credit losses. This brings credit-risk concepts (PD/LGD/EAD, staging, macroeconomic scenarios and model calibration) into the financial statements and increases the need for strong governance, robust data and audit-ready documentation.

### Why ECL is more than an accounting exercise

- ECL affects earnings, equity and (where relevant) regulatory capital - and can create material P&L volatility in periods of macroeconomic stress.
- Impairment outcomes influence key KPIs (EBITDA, ROE/ROA, net debt) and can have knock-on implications for covenants, dividend capacity and investor messaging.
- Audit scrutiny is typically high: stakeholders expect transparent staging logic, defensible assumptions, and a clear explanation of movements period-on-period.
- Disclosures are extensive (credit risk, sensitivity to macro assumptions, and key judgements). The narrative needs to be consistent with how management actually manages credit risk.

### Navigating ECL implementation complexity

- Defining significant increase in credit risk (SICR) and default in a way that is consistent, evidence-based, and operationally implementable.
- Building PD/LGD/EAD methodologies that are appropriately calibrated, segmented and forward-looking - while being proportionate to the portfolio and available data.
- Designing macroeconomic scenarios and probability weightings, including how and when to refresh them and how to explain their impact to stakeholders.
- Managing overlays and post-model adjustments quantification, governance, rationale, and a clear approach to recalibration based on current data.
- Audit-ready controls framework and methodology results pack.

## THE THREE-STAGE ROADMAP FOR COMPLEX FINANCIAL INSTRUMENTS

Financial assets are assessed under a three-stage ECL model, which links impairment recognition to changes in credit risk since initial recognition. Depending on the deterioration in credit quality, assets are measured on either a 12-month or lifetime ECL basis.

### IMPAIRMENT - EXPECTED CREDIT LOSS (ECL) MODEL

Credit risk unchanged since initial recognition

12-month expected credit losses

Phase 1

Interest calculated on the gross carrying amount

Significant increase in credit risk

Lifetime expected credit losses

Phase 2

Interest calculated on the gross carrying amount

Credit-impaired

Lifetime expected credit losses

Phase 3

Interest calculated on the net carrying amount

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## Staging, scenarios, and shortfalls

- Stage 1: Recognise 12-month ECL on initial recognition and while credit risk has not increased significantly.
- Stage 2: Recognise lifetime ECL when a SICR has occurred since initial recognition (even if the asset is not credit-impaired).
- Stage 3: Recognise lifetime ECL for credit-impaired assets; interest revenue is recognised on the net carrying amount (after allowance).
- Staging is reassessed at each reporting date using quantitative and qualitative indicators, including the 30 days past due threshold.
- ECL reflects probability-weighted expected cash shortfalls, including the impact of collateral, guarantees and recovery timing.

## What do I need to analyze?

- Which financial assets and off-balance sheet exposures are in scope (loan commitments, financial guarantees) and how are they segmented for modelling?
- How will we define default and credit-impaired status - and is this aligned with internal credit risk practices and external expectations?
- How will modified or restructured exposures be treated (derecognition vs modification accounting) and what does that mean for staging?
- Are the key model inputs (PD, LGD, EAD, prepayments, collateral values) available with sufficient history and data quality, and is there a clear data lineage?

## CONSIDERATIONS FOR CORPORATES WITH NON-COMPLEX FINANCIAL INSTRUMENTS

Often implemented using a provision matrix, calibrated to historical loss experience and adjusted for forward-looking information.

### Practical application

- Lifetime ECL is recognised from day one (no staging), typically by ageing bucket and customer segment.
- Loss rates are built from observed defaults and recoveries, then adjusted for current and forward-looking conditions (e.g., GDP, commodity prices, inflation, sector outlook).
- Practical considerations include credit insurance, rights of set-off, factoring / receivables sales, and concentration risk.
- Disputed invoices and changes in payment terms often require tailored treatment - they can behave differently from 'clean' ageing data.

### What do I need to analyze?

- Do we have sufficient data to support reliable loss rate calibration by ageing profile, customer segment, and geography?
- What is the most practical approach for forward-looking adjustments, and how should it be updated over time?
- How should non-standard receivables, such as claims, retention balances, contract assets, and long-dated invoices, be assessed within the ECL framework?
- Are collection processes, credit practices, and write-off policies fully aligned with the accounting methodology and supportable?

### Illustrative provision matrix

Bucket and timing cobrability	01/01/X0	03/31/X0	06/30/X0	09/30/X0	12/31/X0	Amount (expected to collect)	Amount (total)	ECL per bucket	% ECL per bucket
Current	14,955,000	44,280	694	24	2	15,000,000	15,000,000	0	0.000%
1 - 30 days past due		7,380,000	115,680	4,035	255	7,499,970	7,500,000	30	0.004%
31 - 60 days past due			3,856,000	134,496	8,497	3,998,993	4,000,000	1,007	0.0252%
61 - 90 days past due				2,335,000	147,510	2,482,510	2,500,000	17,490	0.6996%
More than 90 days past due					894,000	894,000	1,000,000	106,000	10.6000%
<b>Total</b>	<b>14,955,000</b>	<b>7,424,280</b>	<b>3,972,374</b>	<b>2,473,555</b>	<b>1,050,263</b>	<b>29,875,472</b>	<b>30,000,000</b>	<b>124,528</b>	<b>0.42%</b>

## HOW CAN A&M SUPPORT?



### Diagnostic

- Obtain an inventory of in-scope portfolios and reconcile them to the trial balance and ageing reports.
- Review current impairment policies, definition of default, staging criteria (Stage 1/2/3), write-off practices and any management overlays.
- Assess the availability and quality of historical data (defaults, recoveries, collateral) and forward-looking information.



### Methodology & Design

- Define / validate portfolio segmentation and treatment of modifications.
- Design or challenge the approach for estimating PD, LGD and EAD and the incorporation of macroeconomic scenarios / overlays.
- Agree key modelling assumptions - discount rate, time horizon, treatment of interest income, off-BS exposures.



### Model implementation

- Build or review an ECL calculation model by portfolio, stage and scenario.
- Perform high-level back-testing and sensitivity analyses and reconcile outputs to the trial balance or general ledger.
- Assess impacts on the FS, KPIs and covenants, and identify process / control improvements.
- Prepare technical memorandum analysis of the ECL and / or include the accounting policies of the entity.

## CONTACT INFORMATION



### Patricia Alonso de la Fuente

Managing Director, Capital Markets & Accounting Advisory

[p.alonso@alvarezandmarsal.com](mailto:p.alonso@alvarezandmarsal.com)

- 23+ years of financial reporting and transactions experience in USA / EMEA / LATAM.
- Has led numerous purchase accounting and finance integration projects under IFRS and US GAAP, and has advised companies on complex accounting and reporting matters.
- Her experience includes business combinations, revenue recognition, leases, and the implementation of new accounting standards.



### Álvaro López Hilara

Manager, Capital Markets & Accounting Advisory

[alopezhilara@alvarezandmarsal.com](mailto:alopezhilara@alvarezandmarsal.com)

- 6+ years of experience advising clients on complex IFRS accounting and valuation matters.
- His expertise includes financial instruments, hedge accounting, impairment, ECL, business combination, IFRS 9/16 implementation, and complex transactions such as securitizations and Power Purchase Agreements.

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