A focus on IFRS 9 expected credit losses for corporate entities

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How corporate entities can apply the requirements of IFRS 9 expected credit losses (ECL) during the COVID-19 pandemic

At a glance

The COVID-19 pandemic has had and will continue to have far-reaching implications. In many parts of the world, governments have brought in never-before-seen measures including mass quarantines, social distancing, border closures, shut-downs of non-essential services and considerable (in some cases, unlimited) commitments to provide financial support to affected businesses and individuals. Just as the medical implications are emerging and evolving at breakneck speed, so too are those related to the economic and credit environment.

COVID-19 will impact many areas of accounting and reporting for all industries, as outlined in our publication In depth: Accounting Implications of the Effects of Coronavirus. The IASB issued a short document on IFRS 9 and COVID-19 in March 2020. Regulatory authorities have also provided additional guidance for financial institutions. But companies in all industries are facing additional working capital pressure and a likely increase in the credit risk of their receivables. In this Spotlight we focus on the implications for corporate entities (that is, non-financial institutions) when measuring expected credit losses (ECL) on trade receivables, contract assets, lease receivables, intercompany loans and any other financial assets subject to IFRS 9's ECL requirements.

While this Spotlight focuses on ECL, there will be other IFRS 9-related issues including the ability to continue hedge accounting and the implications of debt modifications or working capital improvement projects. Entities are reminded to consider all potential accounting issues. Further guidance on these and other issues is given in the In depth referred to above.

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1. Key messages in the IASB document

As noted above, in March 2020 the IASB issues a short document on the application of IFRS 9 in the light of uncertainty arising from the COVID-19 pandemic**.** The IASB document is intended to support the consistent and robust application of IFRS 9. It acknowledges that estimating ECL is challenging in the current circumstances and that "it is likely to be difficult at this time to incorporate the specific effects of COVID-19 and government support measures on a reasonable and supportable basis." However, the IASB is also clear that "changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings."

Key messages for all entities, including non-financial institutions, include:

- Companies should use all reasonable and supportable information available – historic, current and forward-looking where possible; and
- IFRS 9 does not prescribe any bright lines or a mechanistic approach.

We consider below the implications of this and other guidance for corporate entities.

2. Measuring and presenting expected credit losses (ECLs) – reminder of the core principles and implications of the changing environment

While the uncertainties arising from COVID-19 are substantial and circumstances are certain to change, we do not expect this to preclude entities from estimating their ECLs. Estimating ECLs is challenging, but that does not mean it is impossible to estimate an impact based on the reasonable and supportable information that is available. On transition to IFRS 9, few corporates recognised a material increase in their impairment provisions but ECLs are likely to be higher in the current environment. A few things that may be helpful to keep in mind are:

- Significant judgement will need to be applied in assessing the range of potential outcomes so as to meet IFRS 9's requirement that the ECL reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes, particularly for longer term receivables such as loan receivables or trade debtors and contract assets with a significant financing component. An unbiased estimate is one that is neither overly optimistic, nor overly pessimistic.

- Given the speed with which events are unfolding, measuring ECLs for March 2020 year ends or interim reports is likely to be particularly challenging. Entities will need to develop an estimate based on the best available data about past events, current conditions and forecasts of future economic conditions. Adjustments to expected loss rates in provision matrices and overlays to formal models (where used) will be needed. Updated facts and circumstances should continue to be monitored for any new information relevant to assessing the conditions at the reporting date.

- In terms of the methodology used to estimate ECL, no one size will fit all, and different approaches may work best depending on factors such as local conditions and available data. Certain debtors may receive government support in some countries, while not in others. Whilst such support is designed to compensate for cash flow shortages, it will take time for some of the measures to be put in place and, even once in place, entities may prioritise paying items such as rent or employees over other suppliers. Hence the effects of the government support will need to be carefully considered when factoring this into the likelihood of delayed payment or customer default.

- IFRS 9 always required entities to consider multiple scenarios. However, many corporates might not have done so because it did not make a material difference to the outcome in a benign economic environment. That approach may no longer be appropriate, particularly for entities with longer term loan receivables, and for trade debtors and contract assets where there is a significant financing component.

  In many countries there is little doubt that economic conditions have deteriorated, and this should be reflected in the macroeconomic scenarios applied by an entity and the weighting applied to those scenarios. For example, entities might add one or more scenarios to reflect a more severe downside(s) and/or to increase the weighting allocated to downside scenarios. Core scenarios which assume a very low probability of default may be difficult to support. Estimates are likely to be refined as additional information becomes available that is relevant to assessing conditions at the reporting date.

- Only financial guarantees or other forms of credit insurance that are integral to the financial asset may be taken into account in measuring the ECL. A common example in some groups is where subsidiaries are not permitted to sell to particular customers unless credit insurance or a letter of credit is in place. Even where entities can take the financial guarantee or credit insurance into account, they should remember that this can only reduce the risk of loss - it does not reduce the likelihood of default. Management should also consider whether the party providing the guarantee or insurance is likely to be able to meet its obligations when called upon. This may be particularly relevant for intercompany guarantees of loans in standalone accounts.

- Where contractual payment dates are extended or amounts are expected to be received later than when contractually due, this may give rise to an ECL unless either additional compensation is received for the lost time value of money, or the EIR is 0%. This may particularly affect longer term receivables such as lease receivables, some contract assets and loans. However, in territories where interest rates are low, the impact may be small relative to the impact of credit risk (that is, risk that amounts are never paid).

- IAS 1 para 82 requires presentation of IFRS 9 impairment losses on the face of the income statement as a separate line item. Impairment losses should not be netted off revenue. This separate presentation might not have been given in previous years if the ECL and year on year movements were immaterial. However, there will likely be more focus on this requirement in the wake of COVID-19 and increasing credit risk.

- Disclosures are a critical component of ECL reporting, given the level of measurement uncertainty resulting from COVID-19 (see 5 below).

3. Implications for trade receivables, lease receivables and contract assets measured using the simplified approach

Financial instruments within the scope of IFRS 9's ECL model include trade and other receivables, loan receivables and other debt investments not recognised at fair value through profit or loss (including intercompany loans), contract assets, lease receivables, financial guarantees and loan commitments.

For many corporate groups the main balances subject to ECL will be trade receivables. As required by IFRS 9, a simplified approach of using lifetime ECL is used for measuring the ECL for such trade receivables and contract assets if they do not contain a significant financing component. Entities often calculate ECLs by using a provision matrix. The simplified approach is also permitted for lease receivables and receivables with a significant financing component, but this is an accounting policy choice.

However, forward looking information (including macro-economic information) must still be considered in assessing the credit risk on those balances and in measuring ECL. As noted above, forward-looking information might include one or more downside scenarios related to the spread of COVID-19.

Companies often stratify their receivables into different groupings before applying a provision matrix. For example, a company might sell to customers in different industries some of which are impacted by COVID-19 to a greater degree than others and therefore be exposed to different risks of default. Other factors that might be considered in such stratification would include geographical regions, product type, customer ratings, collateral, and the nature of the customer (for example, wholesale vs. retail).

In considering stratification, it is important to first understand the drivers of credit risk for the underlying receivables and how these may have changed in light of the current pandemic. The level of stratification required is often a matter of significant judgment and in developing segments an entity should consider where further segmentation might be needed. Stratification may go down to the individual customer level in some cases, often described as a specific bad debt provision. For example, where a particular customer is known to be in financial difficulty, it may require an increased provision compared to historical averages over all ageing categories. It is important to consider and avoid any double counting of losses in these situations.

In attempting to model the impact of the pandemic, companies might, as a starting point, look to the behaviour of their customers during previous recessions, thereby using historic credit loss experience as an estimate of future losses. However, given restrictions on both movement and economic activity of a similar magnitude are unlikely to have been experienced in most jurisdictions in modern times, adjustments will need to be made to that historical information to make it supportable in the current period. This could increase the expected risk of default for each time bucket in the provision matrix.

Similarly, some customers may take longer than normal to pay, thus increasing the volume of debtors in the overdue buckets. The extent to which this delay is due to credit risk or is merely an indication of operational issues (e.g. if employees are not able to access their offices) will need to be carefully considered. Many supplier arrangements include the right to charge interest on overdue payments, but in practice it is not always implemented in order to keep good customer relationships. If entities do not intend to charge interest, then it should not be accrued.

The likelihood of debtors paying, and the effect of any government initiatives will also need to be revisited in measuring ECL at the end of each reporting period.

Further information on calculating ECL in a corporate scenario is given in our publication on IFRS 9 impairment practice guide provision matrix: In depth UK2018-03 (https://inform.pwc.com/s/IFRS_9_impairment_practical_guide_provision_matrix_In_depth_UK2018_03/Expected_credit_losses_for_accounts_receivable/informContent/1958155201102387#ic_1958155201102387).

4. Loan receivables, including intercompany balances and other assets not measured using the simplified approach - identifying significant increases in credit risk (SICR)

Where entities are not permitted to follow the simplified approach, or have opted not to, additional information may be needed in order to determine whether a significant increase in credit risk has occurred, and hence whether a lifetime, rather than 12-month, ECL is required. This will apply to all receivables to which the full IFRS 9 model is applied including loan receivables and most intercompany balances. Factors to consider include:

- *Risk of default* - SICR is based on the likelihood of a default arising, and not on the likelihood of losses. Hence, some government relief programmes may not impact SICR assessments. Those programmes that provide cash directly to debtors quickly and thus mitigate the risk of default should be considered but those that make payments directly to the reporting entity to compensate for any losses will not reduce the risk of default on the underlying receivables. If the risk of default has increased, then this may mean that a SICR has arisen, even in cases where it is expected that any losses that arise will be fully recovered. See the In depth: Accounting Implications of the Effects of Coronavirus for further guidance on when such government relief programmes might need to be accounting for or disclosed as government grants.

- *Payment holidays* - where a corporate grants an extension of terms to a counterparty (sometimes referred to as a 'payment holiday') management should assess whether or not this indicates there has been a significant increase in credit risk, given IFRS 9 B5.5.17(m) includes a payment holiday as a potential indicator of SICR. The IASB's document referred to above notes that "the extension of payment holidays to all borrowers in particular classes of financial instruments should not automatically result in all those instruments being considered to have suffered an SICR". However, such 'blanket' payment holidays are not often granted by corporates and whether there has been a SICR should be assessed on a case-by-case basis in the light of the particular facts and circumstances. This may be of most relevance to lessors and they more detailed guidance in the Banking industry Spotlight on ECL provides further guidance.

- *Low credit risk (LCR) exemption from assessing SICR* – The LCR exemption is typically used for securities with an investment grade credit rating from an external credit rating agency or, in a group scenario, for intercompany receivables arising when external debt is transferred from a Treasury or FinCo to an Operating company. However, there is often a time lag between the credit risk increasing and a downgrade of the external credit rating occurring. IFRS 9 only gives an external investment grade credit rating as an example of what *might* be considered to have low credit risk – the broader principle is that 'low credit risk' should be determined with reference to the perspective of a market participant. [IFRS 9 para B5.5.22]. Therefore, even if the external credit rating of a particular debtor is still investment grade, if that is only due to a time lag and a market participant would no longer consider the instrument to have low credit risk, the LCR exemption will not apply and the instrument will need to be assessed for SICR. Management should take this into account when assessing whether the LCR exemption still applies for intercompany loans that were previously deemed to have the same credit rating as other instruments issued by the borrower.
- *Materiality judgements* – Simplifications in previous IFRS 9 ECL measurements justified on the grounds they have no material impact should be revisited in the current environment.

- Further guidance on the calculations required is given in our publication on IFRS 9 Impairment – intercompany loans: PwC In depth 2018-07 (https://inform.pwc.com/s/IFRS_9_Impairment_Intercompany_loans_PwC_In_depth_INT2018_07/Background/informContent/1817244209166263#ic_1817244209166263).

5. Interim reporting under IAS 34 and other disclosure considerations

Many regulators around the world are revising timelines and requirements for interim reporting. When entities do issue interim reports under IAS 34, it will be important to keep in mind the overarching requirement to explain events and transactions since the end of the last annual reporting period that are significant to understanding changes in financial position and performance. Key considerations in meeting that requirement, and when preparing other forms of interim reports, are likely to include:

- *Critical estimates* – Clearly identifying and explaining the critical estimates used in determining ECL will be important. Whilst 31 December 2019 disclosures on critical estimates will in many cases constitute a good starting point, a simple roll-forward of these disclosures is unlikely to be appropriate. There are likely to be new aspects of accounting that have become critical due to the changes in the economic environment and in market dynamics. Hence, past disclosures on previously identified critical estimates may no longer be relevant. If the size of ECLs has become a significant estimate, some regulators expect sensitivities to be provided as IAS 1 suggests that this would be a useful disclosure of an entity's assumptions about the future.

- *Telling the story* – Disclosures should reflect factors that are specific to the entity rather than being boilerplate; and should tell the story of how the estimate was developed. Such disclosures would include describing how the credit and other risks that the entity is exposed to have been impacted by COVID-19, how the impacts of COVID-19 have been incorporated into the ECL estimate, and the extent to which there is uncertainty and hence how estimates might change in the future.

- *Credit risk concentrations and management practices* – In the past corporate entities may not have given much detail on credit risks or their management practices but the level of granularity demanded by investors will likely increase where they have material credit exposures. For example, entities may wish to expand their disclosure of exposures to large and smaller entities or to certain industries, for example, transport or retail and further explain the use of insurance/letters of credit and credit risk management practices.

Conclusion

COVID-19 has given rise to unprecedented challenges that have affected virtually every aspect of modern life. The economic implications of the virus will have a consequent impact on many aspects of accounting and financial reporting. We hope this Spotlight will help you and your advisers as you navigate the key issues as they relate to IFRS 9 ECLs for Corporate entities.

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