IMPAIRMENT IMPLICATIONS OF COVID-19 (IFRS 9 *FINANCIAL INSTRUMENTS)*

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BACKGROUND

The 2019 Novel Coronavirus infection ('coronavirus') or 'COVID-19' outbreak poses a serious public health threat. It has interrupted the movement of people and goods throughout the world, and many levels of government have instituted restrictions on individuals and businesses. The resulting impact on financial reporting will be significant.

BDO has issued the following publications on coronavirus that address the reporting implications in broad terms:

- IFR Bulletin 2020/02 – Potential effects of the Coronavirus Outbreak on 31 December 2019 year-end financial reporting;
- IFR Bulletin 2020/03 – Potential effects of the Coronavirus Outbreak on 2020 reporting periods and onward;
- IFR Bulletin 2020/07 – Impairment implications of COVID-19 (IAS 36); and
- IFR Bulletin 2020/08 – IASB issues amendments to IFRS 16: COVID-19 related rent concessions.

ACCOUNTING IMPACT

The effects of COVID-19 will require entities to adjust their assumptions and systems that interact with the measurement of expected credit losses (ECL).

ECL calculations may also be difficult to perform due to the level of uncertainty created by the effects of COVID-19.

This IFR Bulletin focuses on the financial reporting implications of COVID-19 that relate to the expected credit loss ('ECL') requirements of IFRS 9.

For further resources on applying the requirements of IAS 36 and IFRS 9, please refer to external resources such as IFRS In Practice publications, other IFR Bulletins and online training, which are available on BDO's IFRS Reporting Hub.

SCOPE OF THE ECL REQUIREMENTS

IFRS 9's ECL requirements apply to certain financial assets (including lease receivables) and certain assets arising from IFRS 15. IAS 36 applies to many other assets. As a reminder, the standards apply to:

IAS 36, Impairment of Assets	*IFRS 9, Financial Instruments*
Goodwill	Financial assets classified at amortised cost and debt instruments classified at fair value through OCI, which will commonly include many types of loans and debt instruments
Intangible assets	Trade receivables arising from IFRS 15
Property, plant and equipment	Lease receivables;
Right-of-use assets	Contract assets recognised in accordance with IFRS 15.
Associates and joitn ventures accounted for under the equity method	

The impairment and/or valuation of certain other assets, including inventories, deferred tax assets, assets arising from employee benefits and insurance contracts are covered by other applicable IFRSs.

WHEN THE IMPAIRMENT IMPLICATIONS OF COVID-19 SHOULD BE RECOGNISED

As noted in IFR Bulletins 2020/02 and 03, the effects of COVID-19 are generally a ‘non-adjusting’ subsequent event as at 31 December 2019. Significant government action and intervention began to take place on 30 January 2020 when the World Health Organisation declared coronavirus to be a global health emergency, which generally triggers the recognition of the broad economic effects of the outbreak in financial statements. During the first half of 2020, the effects of the outbreak have evolved and changed, with different timings and effects in different jurisdictions, such that it may be difficult in a practical sense for entities to ‘cut-off’ the information that is relevant as at a particular period end.

The question of incorporating events and information about forecasts of future economic conditions that occur after a period end was discussed at a meeting of the Impairment Transition Resource Group (‘TRG’) in April 2015. The TRG was a group established by the IASB to assist entities in providing support in the implementation of the then new ECL requirements.

The question raised with the TRG noted that impairment calculations may be prepared earlier than the period end date for operational and practical reasons. For example, an entity with a 31 March 2020 period end may prepare a substantial amount of its impairment calculations as at 29 February 2020. This may be done so that the entity is able to issue its financial statements in accordance with applicable filing deadlines.

At these meetings, the TRG noted that if information becomes available after the ECL calculations are prepared but before period end, an entity is required to take this information into account in measuring ECL (e.g. determining if a significant increase in credit risk has occurred, measuring ECL, etc.). IFRS 9 is a probability-weighted estimate of credit losses at the reporting date, therefore information that becomes available about the weighting of potential scenarios and their outcome should be incorporated into the measurement of ECL.

IFRS 9.5.5.17(c) requires entities to measure ECL in a way that reflects reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions. Despite this fact, the measurement of ECL is still subject to the requirements of IAS 10, including the determination of whether information that becomes available subsequent to period end relates to conditions that existed at the end of the reporting period.

EXAMPLE – IAS 10 AND ECL MEASUREMENT

A bank issues loans, which are accounted for as financial assets at amortised cost under IFRS 9. In its 31 March 2020 year-end financial statements, the bank makes various estimates and judgments about the effect of COVID-19 on the amount of ECL calculated for its loan portfolio. On 15 April 2020, subsequent to period end but before the financial statements are completed, the effects of unemployment in the local economy, which are direct effect of COVID-19 as at 31 March 2020, become clearer, and the effects of unemployment on defaults and credit losses now appear to be significantly more severe than originally estimated.

The bank would be required to consider this information in revising its ECL estimate as at 31 March 2020, as the underlying cause (e.g. unemployment and COVID-19) reflected a condition that existed as at period end. It may require significant judgment as at period end to determine which events and circumstances relate to the period end and which do not. Typically, the shorter the period of time between period end and the information becoming available (e.g. a borrower defaulting on a loan shortly after period end), the more likely it is that the information confirms events and conditions as at period end, and therefore, ought to be reflected in ECL calculations.

ECL calculations would not be updated for events occurring subsequent to period end if they do not relate to conditions as at period end.

WHEN TO RECOGNISE ECL

Unlike many impairment calculations required by IAS 36, the recognition of ECL is not 'event-triggered' (e.g. when default occurs). ECL is recognised at all times for any asset subject to those requirements.

Many of the considerations noted in this section are specific to entities applying the 'full ECL' model, where assets are 'bucketed' into 'stages' based on the relative movement in credit risk since initial recognition. This publication also contains guidance at the end of this section for entities that apply the simplified ECL model, which is required for some trade receivables arising from IFRS 15 and is optional for lease receivables arising from transactions within the scope of IFRS 16.

The staging requirements of IFRS 9 and the resulting measurement are summarised as follows:

Change in credit risk since initial recognition

	STAGE 1 No significant increase in credit risk	STAGE 2 Significant increase in credit risk	STAGE 3 Credit impaired
Recognition of impairment	12 month ECL	Lifetime ECL	
Recognition of interest	Effective interest on the gross carrying amount (before deducting ECL)		Effective interest on the net (carrying) amount (after deducting ECL)

EFFECT ON STAGING REQUIREMENTS, 12-MONTH VS. LIFETIME ECL

A movement from stage 1 to either stage 2 or 3 will typically result in a higher ECL, as the probability of default ('PD') over the lifetime of a financial asset will be at least equal to or higher than the PD over the next 12 months.

However, careful consideration will be required. The assessment of whether there has been a significant increase in credit risk (SICR) for a financial asset is carried out on the basis of the expected life of the financial asset, This means that, for example, if it is considered that the severe effects of COVID-19 will be during the second and third quarters of 2020 and that there will be significant initial government support followed by a significant economic recovery from late 2020/early 2021 onwards, then there may not be a SICR for many financial assets (in particular longer term arrangements). In addition, there may be little difference between 12 month and lifetime ECL.

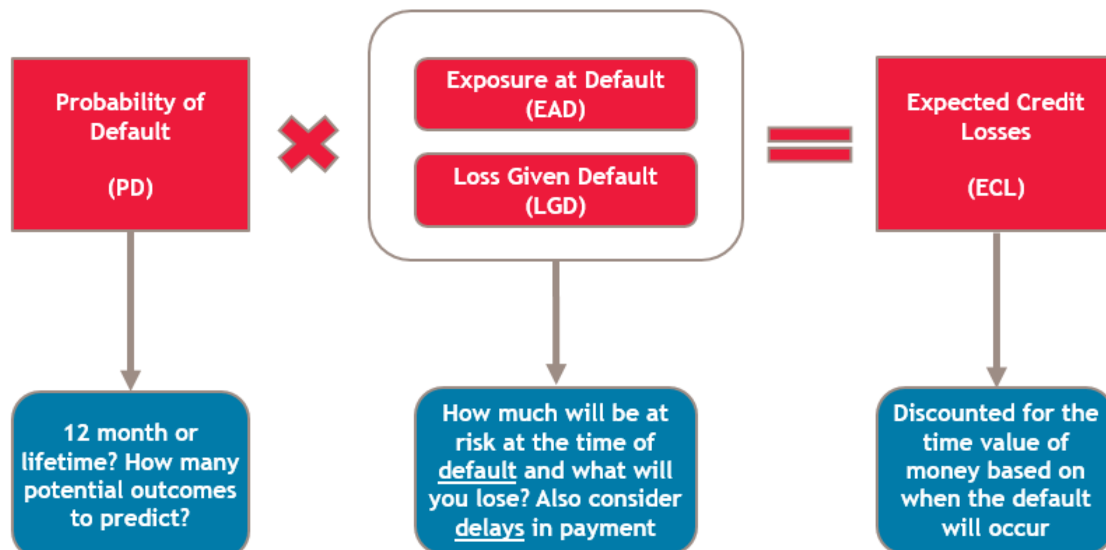
The effects of COVID-19 raise several points that should be considered in determining how financial assets should be staged:

Staging consideration	*BDO Comments*
Modified financial assets	IFRS 9.5.5.12 requires an assessment of whether a significant increase in credit risk has occurred for financial assets that have been renegotiated or modified but not derecognised by comparing: (i) the risk of default occurring at the reporting date (based on the modified contractual terms); and (ii) the risk of default occurring at initial recognition (based on the original contractual terms). COVID-19 may result in many financial assets being modified (e.g. reductions in interest rate, 'grace periods' for payments, etc.), which may increase the prominence of assessing the increase in credit risk for modified financial assets. Entities must carefully analyse the specific facts and circumstances that lead to any change in payment terms. For example, governments may mandate by law or regulation that lenders defer payments for a period of time, which may not necessarily be viewed as resulting in a significant increase in credit risk because, although a borrower may suffer temporary liquidity difficulties, the underlying credit quality may not have deteriorated significantly.
Past due status and the 30 day past due rebuttable presumption	IFRS 9.5.5.11 contains a rebuttable presumption that the credit risk on a financial asset has increased significantly when contractual payments are 30 days past due. Entities cannot rely solely on the '30 day past due rebuttable presumption' if reasonable and supportable forward-looking information is available to determine whether a significant increase in credit risk has occurred. However, some entities may have placed significant reliance on the rebuttable presumption in the past when resultant ECL measurements were less sensitive to a movement between stage 1 and 2/3. Significant qualitative and quantitative factors may exist due to COVID-19 which will require entities to migrate financial assets to stage 2/3 prior to payments becoming 30 days past due (although see the next bullet point for additional considerations due to government intervention). Signs that a significant increase in credit risk may have occurred on individual financial assets or groups of financial assets may include the factors listed in IFRS 9.B5.5.17, as well as: o Unemployment or reductions in income from borrowers that will result in difficulty in servicing debt obligations; o Decreases in asset values that result in loans becoming 'underwater' (i.e. the value of the pledged security has fallen below the loan balance, reducing a borrower's motivation to satisfy its obligation to the lender); o Changes in economic forecasts such as GDP growth, unemployment, consumer confidence, etc.; o Reduced demand for particular goods or services in certain sectors due to business and consumer demand or operational disruption (e.g. disruption to the travel industry may result in significant increases in credit risk); and o Expected breaches of financial covenants.
No significant increase in credit risk despite payment delinquency	For financial assets that have contractual payments that are more than 30 days past due, in some instances it will be appropriate to rebut the presumption that there has been a significant increase in credit risk. As noted above, such 'prima facie' delays in payment may occur due to government intervention, and depending on the circumstances, may not result in a significant increase in credit risk.
Modification losses	Government intervention may result in certain payments due on loans being cancelled for a period (for example, instalments for a three month period). In such cases, a loss will need to be recorded by discounting the revised payments due to their present value (using the original effective interest rate for fixed rate loans and the floating rate at the date on which the payments are revised for floating rate loans).

Staging consideration	*BDO Comments*
Significiant increases in credit risk despite no payment delinquency	Depending on an entity's period end, delinquency on loan payments may not have emerged but credit risk may have increased significantly. In some cases, borrowers may become delinquent on other loans or defer other payments in order to continue servicing key debt (e.g. residential mortgage payments to prevent foreclosure). Other loans may default sooner for similar reasons (e.g. car payments or loans relating to secondary homes such as investment property). Entities must therefore consider the nature of the loan in determining whether a significant increase in credit risk has occurred.
Segmentation of portfolios	Due to the broad nature of the effects of COVID-19, it may not be possible for entities to identify specific assets that have experienced a significant increase in credit risk. This may occur when entities have thousands or even millions of small loans. Despite this, considering the other factors noted above, entities may need to determine whether a significant increase in credit risk has occurred on a group or 'aggregated' basis (IFRS 9.B5.5.4 and B5.5.5). This grouping of financial assets should not 'shield' financial assets from migrating within the stages of IFRS 9, therefore, the groupings should be granular enough in nature such that the underlying financial assets share common credit risk characteristics, such as: o Instrument type (e.g. residential mortgages, loans to businesses in a particular industry, etc.); o Credit risk rating; o Collateral type; o Date of initial recognition (i.e. creating 'vintages' of loans within other subsets of loans such as residential mortgages); o Remaining term to maturity; o Industry; o Geographic location of the borrower; and o The value of collateral relative to the financial asset if it impacts the PD (e.g. non-recourse loans).

EFFECT ON MEASUREMENT OF ECL

The measurement of ECL is summarised as follows:



The staging of a loan, as discussed in the previous section, determines whether the PD is estimated over a 12-month period or the lifetime of the financial asset. In either case, the loss given default is estimated based on the lifetime credit losses occurring from default events in the relevant period (e.g. over the next 12 months or the lifetime of the instrument). Credit losses include cash shortfalls as well as delays in payment, since ECL is a present value calculation (i.e. even if an entity expects to recover 100% of a loan, if the entity expects it to take 18 months longer than the contractual payments, an ECL is recognised).

ECL is an 'expected value', not a single point estimate, meaning it is a weighted average of credit losses based on the respective risks of a default occurring, which must consider at a minimum two scenarios: credit loss occurring and credit loss not occurring (IFRS 9.B5.5.41).

The number of potential scenarios included in the ECL calculation may need to increase due to the effects of COVID-19, along with the respective probability weightings. In addition, it is very likely that there will be a need for additional 'overlays' that are used to adjust the amounts derived from models. This is because many models and software systems designed to calculate ECL will not be calibrated to address the effects of COVID-19 given its sudden emergence and the severity of its impacts. See the following section 'IFRS 9 – system implications'.

The effects of COVID-19 raise several points that should be considered in determining ECL:

ECL measurement consideration	*BDO Comments*
Interaction with staging requirements (earlier section)	As noted in the earlier section, additional financial assets are likely to migrate from stage 1 to 2/3, in many (but not necessarily all) cases resulting in an increase in ECL.
Probability of default for defaulted loans	More assets will default, resulting in an increase in ECL as the PD for credit-defaulted loans is 100%.
Lifetime expected credit losses	In determining the effect of COVID-19 on the expected cash shortfalls, lenders should consider the extent to which entities may default on the timing of contractual payments, but may relatively quickly be able to return to compliance with the contractual terms of the instrument. The effects of COVID-19 will result in some entities that will default and never be able to fulfil their contractual obligations, however, many entities may be able to do so if sufficient time is provided. Entities should consider that the determination of a SICR is based on the expected life of financial assets, and that ECL is based on lifetime expected cash shortfalls, and not focus measurement entirely on the 'short-term' shock that may result from the impacts of COVID-19.
Increases in assets at risk prior to default	The exposure at default (i.e. how much the lender has at risk at the time of default) may continue to increase prior to default as borrowers may continue to draw on revolving facilities such as lines of credit as other sources of income are reduced.
Historical information	In measuring ECL, entities may have relied on historical data as the base case for their estimates, with an adjustment for forward-looking information. The extent to which historical data needed to be adjusted for forward looking information may have been relatively minor if management felt that past default rates and losses given default were indicative of the future. This may have been the case given the relatively benign economic environment prior to the COVID-19 global outbreak. It is now highly unlikely that past experience will be indicative of future losses, as the breadth of COVID-19's effects is unprecedented. Therefore, the extent to which forward-looking information

ECL measurement consideration	*BDO Comments*
Historical information (continued)	will affect historical data, and in consequence ECL measurement, will generally change significantly.
Value of collateral	As ECL considers credit enhancements and security relating to the financial asset, the effects of COVID-19 on the value of assets pledged as collateral must be considered. For example, if COVID-19 results in reductions in the value of commercial real estate, then the ECL on a related commercial mortgage may increase depending on the extent to which the mortgage amount is covered by the fair value of the real estate.
Impact of government intervention	Government intervention that has been committed to before the period end may affect whether there is a SICR, and may reduce PD or the LGD. For example, if governments commit to direct financial assistance (e.g. cash payments to individual and businesses), their ability to service financial obligations will increase and the extent to which there is a SICR, and the PD will be reduced. In other cases, government assistance may not affect the assessment of whether there has been a SICR or the associated PD, but will decrease LGD (e.g. a government guaranteeing a loan in the event that a borrower defaults does not affect the assessment of SICR or the associated PD, but the cash shortfall upon default would decrease).
Modelling the effects of COVID-19	Modelling and estimating the impact of COVID-19 will be challenging as it is unlike any previously encountered financial crisis or 'stress' on existing systems and processes, especially since IFRS 9 became effective. Entities must undertake a 'best efforts' basis for determining the effects and be responsive in adjusting modelling techniques, assumptions and disclosures in subsequent periods as uncertainties change. It will also be necessary to ensure that significantly adverse downside scenarios are built into forecasts while significant uncertainties remain.

SYSTEM IMPLICATIONS

For many entities, the calculation of ECL may be driven by underlying software, computer models and algorithms. These systems may not be calibrated to address the impacts of COVID-19, especially given how rapidly the outbreak has developed. This may be because such systems rely on historical information to drive base calculations, and methods of tracking relative movements in credit risk may not be immediately responsive.

Additionally, the models developed may respond to inputs in a manner that requires manual adjustment or 'overlays'. For example, if an entity were to determine that deferrals of payments do not result in a significant increase in credit risk, this may conflict with the default methodology embedded in a system or model. Such systems may automatically determine that financial assets have experienced a significant increase in credit risk once payments become 30 days past due but, as noted earlier, this may be rebutted in some situations, requiring manual adjustments to models.

Entities may need to consider an 'overlay' on top of existing processes and systems in the short-term. This may be achieved by adding additional manual calculations to adjust the amount of ECL.

CONSIDERATIONS FOR ENTITIES APPLYING THE 'SIMPLIFIED' ECL MODEL

A 'simplified' ECL model is required to be applied, where ECL is always measured based on the lifetime ECL (IFRS 9.5.5.15) for trade receivables if specified criteria are satisfied (the simplified model is optional for lease receivables). Many of the considerations in this publication will apply to entities applying the simplified model, except that the 'staging' requirements will not be applicable. For example, an entity may have used a provision matrix based on historical default rates, adjusted for forward-looking information as follows:

	Expected default rate (A)	Gross carrying amount (B)	Credit loss allowance (A*B)
Current	0.5%	CU16m	CU80k
1-30 days past due	1.8%	CU8m	CU144k
31-60 days past due	3.8%	CU5m	CU190k
61-90 days past due	7%	CU3.5m	CU245k
>90 days past due	11%	CU1.5m	CU165k
Total		CU34m	**CU824k**

The effects of COVID-19 will require entities to revisit the adjustments made to historic loss rates and the extent to which they are updated for forward-looking information. In doing so, entities should consider the nature of their trade and/or lease receivables and their customer base. For example, entities may need to consider segmenting their trade receivable balances into sub-portfolios based on customers with higher credit risk (e.g. restaurant and hospitality industry) and lower credit risk (e.g. medical supply firms) and adjusting historic loss rates at this more granular level.

IFRS 7 - DISCLOSURES

IFRS 7 requires extensive disclosures relating to ECL and the credit risk to which an entity is exposed by its financial assets. The effects of COVID-19 raise several points that should be considered in disclosing quantitative and qualitative information about an entity's exposure to credit risk and measurement of ECL:

- How credit risk management practices have been affected;
- How the segmentation of financial assets has been affected (e.g. have groups and/or portfolios been further sub-divided or regrouped);
- Whether risk concentrations have changed (e.g. has ECL increased significantly relating to specific sub-portfolios or types of financial assets);
- How systems have been updated to address the effects of COVID-19, including how the entity is assessing significant increases in credit risk and how those processes have changed;
- Significant assumptions underlying ECL measurement (e.g. how scenarios were developed and weighted that were incorporated);
- Revisions to the entity's definition of default or write-off policy;
- The basis of inputs into the assessment of SICR, and both 12-month and lifetime ECL, which may have changed significantly due to COVID-19); and
- How forward-looking information has been incorporated.

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