Guidance on Likely Impacts of COVID-19 for Expected Credit Loss

NSW GOVERNMENT | Treasury

Introduction

The current Covid-19 pandemic has significantly changed the economic environment. These changes and the associated uncertainties are likely to impact material accounting judgements and estimates, including expected credit losses (ECLs).

This guidance identifies considerations arising from Covid-19. The guidance therefore only provides a brief summary of the requirements in AASB 9 *Financial Instruments* (AASB 9), and agencies should refer to AASB 9 when determining ECLs. Further guidance on ECLs is also contained in the following Treasury publications:

- TPP19-05 *Accounting for Financial Instruments* (June 2019); and
- Overview on AASB 9 *Financial Instruments* published.

Summary of general principles

AASB 9 is effective from the financial year ended 30 June 2019. It requires impairment assessments of financial instruments to be based on the “expected credit losses (ECL)” model.

ECL can be measured using either of the following bases, depending on the circumstances:

- 12 month expected credit losses - the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date; or

- Lifetime expected credit losses - the expected credit losses that result from all possible default events over the expected life of a financial instrument [AASB 9.Appendix A].

<u>Simplified approach</u>

NSW Treasury has mandated the loss allowance for the following items to be always equal to lifetime ECL (i.e. the simplified approach):

- trade receivables (NSW Treasury also mandates the practical expedient of using a provision matrix);
- contract assets; and
- lease receivables.

General approach
Under the general approach, the ECL is measured at lifetime expected credit losses if, at the reporting date, the credit risk on the financial instruments has increased significantly since initial recognition. Otherwise, the ECL is measured at 12 month expected credit losses. The general approach should be adopted for the following items:

- advances paid;
- cash and bank deposits;
- term deposits;
- loans receivable;
- investments in bonds classified as amortised cost of FVOCI;
- financial guarantees; and
- loan commitments.

Factors that should be considered for ECL assessments
The ECL is the present value of a probability weighted estimate of credit losses. Therefore, the measurement of ECL should reflect (AASB 9.5.5.17):

- an unbiased evaluation of a range of possible outcomes and their probabilities of occurrences (i.e. it cannot be based on the best or worst case scenario only);
- the time value of money (i.e. the impact of discounting); and
- 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 (i.e. the ECL assessment is forward looking and should not be based on historical data only).

NSW government entities are encouraged to refer to Section 6 *Impairment of Financial Assets* of TPP19-05 *Accounting for Financial Instruments* for more guidance and examples on assessing ECLs.

Special considerations in the COVID-19 economic environment

Impact of Covid-19 on ECL assessments
The current economic environment has negatively impacted the operations of most businesses. In some instances, this will affect the ability of businesses to settle their obligations to trading partners and government agencies. This will need to be considered by counterparties when estimating ECLs at 30 June 2020.

Some Government responses to Covid-19 will also impact on ECLs. For instance, deferment of payments for receivables, will increase the receivables balances at 30 June 2020. This may also, although not necessarily[1], increase the credit risk of the receivables.

Agencies will need to consider the impact of COVID-19 on both the appropriate ECL method under AASB 9 and the assumptions used to perform the calculations.

[1] The IASB guidance on 'IFRS 9 and COVID-19' states: "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."

Potential change of the ECL assessment basis

For financial instruments using the General Approach, where the credit loss allowance is currently measured at a *12-month expected credit losses*, agencies should assess whether the credit risk (risk of default) has increased significantly since initial recognition. If so, the ECL should be measured at the *lifetime expected credit losses* rather than the 12-month ECL [AASB 9. 5.5.3].

Potential change in ECL measurement

Expected credit losses may increase, regardless of whether the 12-month or lifetime ECL model is applied. This is because assumptions and inputs in the ECL calculation will change. For example:

- Increased credit risk associated with debtors, as a result of poor trading conditions.
- Higher receivables balances (i.e. exposure at default) due to credit deferment policies of Government and/or late payment.
- Lost time value of money, if contractual payment dates are extended or amounts are expected to be received later than when contractually due.
- Potential decreases in the fair value of non-financial assets pledged as collateral.

<u>Use of forward-looking information</u>

AASB 9 requires forward-looking information to be considered both when assessing whether there has been a significant increase in credit risk and when measuring ECLs. Forward-looking information includes customer specific information such as payment status, and macro-economic information such as changes in unemployment rates, property prices, commodity prices, etc.

Forward-looking information might give rise to additional downside scenarios related to the spread of COVID-19. Inclusion of the relevant forward-looking information in ECL assessments can be achieved by:

- Adding one or more additional scenarios to the entity's existing scenarios in the ECL assessment (e.g. prior to COVID-19, the entity's ECL assessment includes 10% loss, 20% loss and 30% scenarios; due to the expected impact of COVID-19 on certain customers, a scenario of 50% loss for this customer group is added);
- Amending one or more of the existing scenarios, for example, to reflect a more severe downside(s) and/or to increase their weighting (e.g. prior to COVID-19, the entity's ECL assessment includes 10% loss, 20% loss and 30% scenarios; due to the impact of COVID-19, the expected loss rate from the customer group previously of a 30% loss rate is expected to increase significantly. As a result, its expected loss rate is amended from 30% to 50%) ; or
- Using an 'overlay' if the impact is not included in the entity's main ECL model (see the illustrative example below).

Illustrative example of using an "overlay": Inclusion of forward-looking information when using a provision matrix

The credit risk profile of receivables for Entity A is analysed based on their past due status. Entity A determines the expected credit losses on its receivables by using a provision matrix, with the expected loss rates based on historical observed loss rates. This is adjusted to reflect current and forward-looking information, based on macroeconomic factors affecting the ability of the customers to settle the receivables.

Entity A's receivables as at 30 June 2020 and the historical loss rates are as follows:

	0 days past due	**1-30 days past due**	**31-60 days past due**	**61-90 days past due**	**More than 90 days past due**
Receivables balance	$10,00,000	$5,000,000	$3,000,000	$2,000,000	$1,000,000
Historical loss rate	1%	2%	5%	9%	19%

Due to the economic downturn, there is expected to be a significant increase in the unemployment rate as at 30 June 2020. Management of Entity A estimates that the increase in unemployment is highly likely to result in increases in defaults. The last time that there was a similar significant downturn in employment, receivable losses increased on average by 10%* *(Note: this is a hypothetical example only. Each agency should assess the impact based on the entity's specific circumstances).* Consequently, the historical loss rates should be adjusted by 10% to reflect the current economic forecast.

The expected credit losses as at 30 June 2020 are calculated as follows:

	0 days past due	**1-30 days past due**	**31-60 days past due**	**61-90 days past due**	**More than 90 days past due**
Receivables balance	$10,00,000	$5,000,000	$3,000,000	$2,000,000	$1,000,000
Expected credit loss rate	1.1%	2.2%	5.5%	11%	22%
Expected credit losses	110,000	110,000	165,000	220,000	220,000

**It is worth noting that the increase of 10% may not necessarily be the same across all bands. To simplify the illustration, we assume it is in the example.*

Impact on disclosures

Management should consider the need to disclose information about the impact of Covid-19 on the impairment of financial assets.

ECL is an estimation of losses. Due to Covid-19, there is likely to be increased uncertainty regarding assumptions in the ECL assessment. AASB 101 *Presentation of Financial Statements* (AASB 101) requires entities to disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that **have a significant risk of resulting in a material adjustment** to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of (AASB 101.125):

(a) their nature, and
(b) their carrying amount as at the end of the reporting period

Therefore, management should assess whether the assumptions and uncertainties involved in their ECL assessments have a significant risk of resulting in a material adjustment to the carrying amount of the related financial assets within the next financial year. The relevant disclosures, if AASB 101.125 as described above is applicable, may include (AASB 101.129):

- the nature of the assumption or other estimation uncertainty;
- the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
- the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets affected; and
- an explanation of changes made to past assumptions concerning those assets, if the uncertainty remains unresolved.

Apart from the general requirements from AASB 101 as above, management should also consider the relevant disclosure requirements specific to financial instruments. For example, disclosures required by AASB 7 *Financial instruments: Disclosures* that might be affected include:

- how the impact of forward-looking information has been incorporated into the ECL estimate;
- details of significant changes in assumptions made in the reporting period; and
- changes in the ECL that result from assets moving from 12 month ECL to lifetime ECL.

Consideration of other relevant Australian Accounting Standards

As well as the impact on ECL assessments, as part of subsequent measurement of financial assets, agencies should also be aware of the impact of Covid-19 on the application of other relevant Australian Accounting Standards on the initial recognition of financial assets (such as receivables) and the corresponding income recognition.

For example, AASB 1058 *Income of Not-for-Profit Entities* (AASB 1058) requires the recognition of income upon the initial recognition of an asset received using the residual approach (AASB 1058.9 and AASB 1058.10). According to AASB 1058.12, the entity should initially recognise the asset received, including a financial asset received, at fair value. This is consistent with the requirement of the relevant requirement in para 5.1.1 and 5.1.1A of AASB 9 *Financial Instruments* that a financial asset should be initially recorded at its fair value (which is usually but not necessarily the transaction price).

Fair value is defined in para 9 of AASB 13 *Fair Value Measurement*, which is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Therefore, agencies should take into account of any foreseeable uncollectable amount, in particular caused by COVID-19, at the initial recognition date of the financial asset when recognising the receivables and corresponding income.