Educational material 11

APPLICATION OF IFRS STANDARDS IN LIGHT OF THE CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY

IFRS 9 *Financial Instruments* – measurement of expected credit losses on trade receivables

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Disclaimer

Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.

1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS that are relevant for entities considering how the pandemic affects their accounting, for financial periods ending after 31 December 2019 with a focus on IFRS 9 *Financial Instruments* (IFRS 9) and specifically the requirements related to the measurement of expected credit losses on trade receivables and related disclosures required under IFRS 7 *Financial Instruments: Disclosures.*

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements. This guidance does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

2. Measurement of expected credit losses on trade receivables

The impairment requirements in IFRS 9 are based on an expected credit loss (ECL) model and applies to financial assets that are debt instruments measured at amortised cost or at fair value through other comprehensive income (IFRS 9.5.5.1-2). In applying the IFRS 9 impairment requirements, an entity applies either the general approach or a simplified approach. (IFRS 9.5.5.3; IFRS 9.5.5.13-16)

Under the general approach, ECLs are recognised based on either a 12-month ECL or lifetime ECL depending on whether there has been a significant increase in credit risk of a financial asset (or other exposure) since initial recognition. (IFRS 9.5.5.3)

The simplified approach requires the recognition of lifetime ECLs, from the date of initial recognition, at the reporting date and is particularly relevant for corporate entities that hold trade receivables. An entity is required to apply the simplified approach for trade receivables that result from transactions within the scope of IFRS 15 *Revenue from Contracts with Customers* and that do not contain a significant financing component[1]. For trade receivables with a significant financing component, an entity has an accounting policy choice to apply either the general approach or simplified approach. (IFRS 9.5.5.15(a)(i))

The measurement of ECLs under the simplified approach considers many of the same principles under the general approach. Some of these key principles include the requirement to:

— Measure ECLs as an unbiased, probability-weighted amount, using reasonable and supportable information that is available without undue cost or effort at the reporting

1 Paragraph 60 of IFRS 15 describes contracts with a significant financing component as those for which the agreed timing of payment provides the customer or the entity with a significant benefit of financing on the transfer of goods or services to the customer and, hence, in determining the transaction price, an entity is required to adjust the promised amount of consideration for the effects of the time value of money.

date. This includes information about past events, current conditions and forecasts of future economic conditions. (IFRS 9.5.5.17)
— Consider a range of possible outcomes and their respective probabilities, and to apply judgment when determining what constitutes reasonable and supportable forward-looking information. (IFRS 9.B5.5.42)

This guidance document considers issues particularly relevant to the measurement of ECLs for trade receivables under the simplified approach.

Applying provision matrices

IFRS 9 permits the use of practical expedients when measuring ECLs provided that they are consistent with the measurement principles set out in paragraph 5.5.17 of IFRS 9 (outlined above). An example of a practical expedient is the calculation of ECLs on trade receivables using a provision matrix. Applying a provision matrix, an entity would use its historical loss experience for trade receivables to measure ECLs. (IFRS 9.B5.5.35)

Historical credit loss information should however be adjusted with current observable data to reflect the effects of the current conditions and its forecasts of future conditions that did not affect the period on which the historical data is based, and to remove the effects of the conditions in the historical period that are not relevant to the future contractual cash flows. (IFRS 9.B5.5.51)

Estimates of changes in ECLs should reflect, and be directionally consistent with, changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial instrument or in the group of financial instruments and in the magnitude of those changes). (IFRS 9.B5.5.51)

An entity that applies a provision matrix may also apply segmentation to its customers by using appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer. (IFRS 9.B5.5.35)

With the onset of the COVID-19 pandemic, applying the IFRS 9 requirements for provision matrices to measure ECLs for trade receivables may introduce additional considerations. These include the following:

— Adjusting provision matrices to incorporate reasonable and supportable information relating to the impact of COVID-19 that is available at the reporting date[2] (IFRS 9.5.5.17). This could include the impact of additional economic scenarios (for example the impact of a recession or downturn) or the impact of government economic relief measures where related to the trade receivable.

[2] The extent of the ECL measurement impact in relation to COVID-19 depends on the specific reporting date under consideration and information available at that date. Refer to Education material 1 – IAS 10 events after the reporting period for guidance on adjusting and non-adjusting events after the reporting date.

— Entities may need to reassess and update ECL estimates for changes in future economic conditions relative to historic experience given the severity of the economic impacts of COVID-19. Entities may also need to consider a longer time horizon such as when payment dates are deferred for a significant period. (IFRS 9.5.5.17)
— Entities should consider any lagging borrower-specific factors that could impact the ECL estimate (IFRS 9.B5.5.2). Debtors may be assessed as currently performing but this could only be due to a time lag where the extent of credit deterioration of the debtor due to COVID-19 has not fully emerged.
— COVID-19 may lead to a significant increase in historical loss rates for many trade receivables when adjusted to reflect information about current conditions and reasonable and supportable forecasts of future economic conditions. Entities may need to consider how COVID-19 would affect the cash flows generated by outstanding trade receivables (both timing and amount) and assess whether an increase in these historical loss rates used is required. (IFRS 9.B5.5.51)
— The segmentation of customers applied in previous periods, if applicable, may no longer be appropriate and may need to be revised to reflect the different ways in which COVID-19 affects different types of customers. For example, COVID-19 may change the risk characteristics of certain trade receivables based on their industry or location and may need to be re-segmented.

Other measurement considerations

Paragraph 9.5.1.3 of IFRS 9 outlines that trade receivables, without a significant financing component, are measured on initial recognition at the transaction price determined in accordance with IFRS 15 (IFRS 9.5.1.3). These trade receivables do not have a contractual interest rate hence their effective interest rate is zero. Discounting cash shortfalls associated with these trade receivables to reflect the time value of money when measuring ECLs is not required.

However, an issue may arise if trade receivables are renegotiated or modified because they are not paid when they fall due as a result of the COVID-19 economic impact. In these circumstances, entities may need to revise the effective interest rate for the purposes of discounting expected future cash flows. This is because the re-negotiation may effectively incorporate a significant financing component such that it may not be appropriate to use an effective interest rate of zero.

There may also be other challenges relating to whether the modification of the trade receivable is considered to be substantial or not. In particular, if the modification is substantial, this results in derecognition of the trade receivable and recognition of a new financial asset. If on the other hand the modification is considered to be non-substantial, the trade receivable is not derecognised. In accordance with paragraph 5.4.3 of IFRS 9, the gross carrying amount of the trade receivable is recalculated and a modification gain or loss is recognized in profit or loss.

3. Disclosures

Paragraph 31 of IFRS 7 *Financial Instruments: Disclosures*, requires an entity to disclose the nature and extent of risks arising from financial instruments and how it manages those risks. In applying this disclosure requirement, entities may need to use judgment when considering the impact of COVID-19 on the risks arising from trade receivables and how those risks are managed. In particular, some of the disclosures set out in IFRS 7 should be expanded on to consider the impact of COVID-19, which are:

- Information about a company's credit risk management practices and how they relate to the recognition and measurement of ECLs (IFRS 7.35F). These include:
  - Extension of payment terms to customers
  - Relief measures offered to customers such as payment holidays
  - Financial support or guarantees offered to customers by their holding companies or other related parties.
- The methods, assumptions and information used to measure ECLs and how updated forward-looking information has been incorporated (IFRS7.35G). For example, relevant disclosures may include information about how provision matrices were updated to incorporate the economic impact of COVID-19.
- Quantitative and qualitative information that enables evaluation of the amounts arising from ECLs. (IFRS7.35 H-L).
- Information on the assumptions that the entity has made about the future and other major sources of estimation uncertainty at the reporting date that have a significant risk of resulting in material adjustment within the next financial year (IAS 1.125). To assist users in understanding the judgments that management makes about the future and about other sources of estimation uncertainty, entities should consider the following disclosures:
  - 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 and liabilities affected; and
  - an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved. (IAS 1.129)

Credit risk concentrations

The COVID-19 pandemic may also have an impact on disclosures relating to the grouping of trade receivables into different credit risk concentrations. This is based on paragraph 35B(c) of IFRS 7 which requires entities to disclose information about their credit risk exposure including significant credit risk concentrations.

Paragraph B8H of IFRS 7 expands on this requirement and states that a concentration of credit risk exists when a number of counterparties are located in a geographical region or are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

In this regard, entities may find themselves subject to increased concentrations of risk as a result of COVID-19 and may need to consider whether there are concentrations that are particularly affected as a result of their activities, industries, location etc.

If this is the case, paragraph B8H of IFRS 7 requires entities to provide information that enables users of financial statements to understand whether there are groups or portfolios of financial instruments with particular features that could affect a large portion of that group of financial instruments such as concentration to particular risks for example, loan-to-value groupings, geographical, industry or issuer-type concentrations.

Entities may also consider applying the requirements of paragraph 34(c) and B8 of IFRS 7 for concentrations of risk in general. More specifically, paragraph B8 of IFRS 7 states that disclosures of concentrations of risk shall include:

— a description of how management determines concentrations;
— a description of the shared characteristic that identifies each concentration (e.g. counterparty, geographical area, currency or market); and the amount of the risk exposure associated with all financial instruments sharing that characteristic.