Grant Thornton

IFRS 9 Financial Reporting Issues in times of COVID-19

In December 2019, IFRS 9 (Financial Instruments) was in its second year of reporting. Although considered as one of the more complex IFRS standards, most data issues, judgments and estimation complexities had already been addressed and expected credit loss (ECL) models were now in somewhat of a stable condition having been validated by independent experts and auditors.

With no major standards or amendments coming into play in 2020, the financial reporting for 2019 was expected to be straight forward.

However, no one could expect what lay ahead in the first few months of 2020, how the global pandemic would affect every aspect of the world we once knew. The next 3 months would bring not only severe personal challenges but also unprecedented challenges for governments and companies alike.

These challenges would also affect international reporting standards, including IFRS 9. The International Accounting Standards Board (IASB) also released a document in March 2020 responding to questions regarding the application of IFRS 9 during the COVID-19 pandemic in which they mentioned that a number of assumptions and linkages underlying the way ECLs have been implemented to date may no longer hold in the current environment. As a result, IFRS 9 models had to be reevaluated for their accuracy of results.

Below we identify 4 key areas of IFRS 9 which may need more focus during the current financial reporting cycle.

1. Business model challenges
2. Identifying and assessing the Significant Increase in Credit Risk (SICR)
3. Identification of values of forward looking macro-economic variables and assigning weightages to the economic scenarios
4. Use of overlays approach when uncertainty is the only certainty

1. Business model challenges

Imagine a year ago, an entity had an established business model for a group of financial assets that would be managed with a 'business objective' of collecting the contractual cashflows. The business objective would not be very difficult to assess at that time. There would be some expectation of economic downturn (due to economic cycle or consistent drop in oil prices or remote probability of war in the region), however, rightly so, the entity would not have considered the 'worst case' scenario in assessing the business model. The group of financial assets would therefore have been classified at amortised cost.

Fast forward a year later, the entity now faces 2 dilemmas.

First: the 'business objective' may have fundamentally changed from a growth objective to a survival objective, i.e. to save itself from going into liquidation and to hold cash reserves to continue operations and pay salaries to its work force.

Second: what may have been the 'worst case' scenario a year ago, may now be a 'base case' or possibly "only case" scenario. Now, the entity may want to sell all its trade receivables to a factoring company without any recourse with transfer of substantial risks and rewards.

The above situation will fundamentally change the financial reporting and trade receivables will now require to be classified as value through profit or loss (FVTPL) or fair value through other comprehensive income (FVOCI), with all fair value changes (most probably negative changes) affecting equity and ultimately the health of the balance sheet.

2. Identifying and assessing the SICR (Significant Increase in Credit Risk)

Amid the deteriorating global economic scenario, entities and especially financial institutions and banks are facing the challenge of an unprecedented increase in the number of requests for changes in credit terms, loan modifications, extended payment terms, payment holidays and similar financial arrangements to provide some breathing space for businesses.

Lenders were immediately and fundamentally posed by challenges with deciding whether the borrowers were faced with financial difficulty and subsequently should the lenders assess that there's a significant increase in credit risk (which will be a substantial part of the loan book). This in turn would result in a reclassification of these loans to Stage-2, i.e. lifetime ECL.

The effect of putting an exposure into Stage-2 (or Stage-3) would be 3-fold, i.e. an increase in probability of default (PD), an increase in exposure (since the borrower may draw down all committed irrevocable lines of credit to sustain the business) and a decrease in the value of collateral. All of which would negatively impact the ECL measurement.

The result of the above is not merely an accounting entry, rather a potential devastating result for the individual lender's financial statements as well as potentially lead to a vicious circle of debt trap which in turn could put the whole economy in danger.

The IASB, in their COVID-19 guidance paper, identified that the extension of payment holidays to all borrowers, in particular classes of financial instruments, should not automatically result in all instruments being considered to have suffered an SICR.

The Central Bank of the UAE (CBUAE) launched the Targeted Economic Support Scheme (TESS) for affected private sector corporates, SMEs and individuals in March 2020.

In April 2020, CBUAE, DIFC and ADGM also produced comprehensive guidance, with the following key points:

- Banks and finance companies are required to group borrowers into the following categories:
    - o Clients who were offered payment deferrals and who are under the TESS programme;
    - o Clients who were offered payment deferrals but who are not under the TESS programme; and
    - o Clients who were not offered any payment deferrals.
- No staging changes will be made for clients who are mildly affected, whereas if clients are significantly affected and there is SICR these should be downgraded to Stage 2 and in exceptional cases to Stage 3.
- Banks and finance companies are not encouraged to re-calibrate IFRS 9 models during the crisis due to the high degree of uncertainty.
- Input adjustments and judgmental overlays should be considered for exposure at default (EAD) model adjustments and macroeconomic model adjustments.
- Macroeconomic scenarios should be updated by September 2020.
- Even clients not benefitting from repayment deferrals can be indirectly impacted by the COVID-19 crisis and therefore the SICR triggers currently in place, should be applied cautiously and subject to exercise of judgement.

3. Identification of values of forward looking macro-economic variables and assigning weightages to the economic scenarios

In assessing forecast conditions, consideration should be given both to the effects of COVID-19 and the significant government support measures being undertaken.

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, changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings. If the effects of COVID-19 cannot be reflected in models, post-model overlays or adjustments will need to be considered.

Many countries have rightly realised that an economic deterioration is underway which may extend further. Once macroeconomic models are ready, this should be reflected by using additional scenarios to reflect a more severe downturn or changing the weightages of the existing scenarios.

4. Use of overlays approach when uncertainty is the only certainty

Considering the current challenges, entities will face difficulties to develop the models which can provide results without any gaps in the expectation, although at this stage it is also difficult to develop any kind of expectation about the future.

To develop the expectation, we need to apply judgement to statistical models which can then derive a mathematical relationship between a certain economic variable (e.g. GDP) with the risk of defaults. The challenge lies in the fact that there is no historical precedence to develop such relationships. The economic recovery from the current situation lies in medical and psychological recovery.

These extreme economic conditions coupled with uncertainty around the duration of the pandemic, potential relapses, possibility of a second wave of infection, effects of government support and what recovery will ultimately look like, mean that forward-looking judgements are highly uncertain and challenging to make.

In such situations, regulators around the globe are reluctant to allow banks and financial institutions to revise their models and prefer that they use the post model adjustments or overlays in the intervening period.

Overlay, in simple business terms, means when we cannot assess a result with accuracy, we develop a range of adjustments that are made outside of model. This can be as simple as applying a % on the model result or as complex as developing various ranges applying the judgements under the supervision of economists and financial experts. This overlay is used to fill the gaps due to unavailable data or gaps in modelling.

The following are examples of the most important factors when using a post model adjustment:

- There has to be a robust governance process and documented policy on how overlays are built and how and at what frequency these will be monitored, including how these will be reversed in subsequent periods post COVID-19 or when models are successfully updated.
- How key management's KPIs will be monitored while using an overlay.
- It has to be ensured and documented that all reasonable and available data is already used, and overlay is used only as a last resort.
- There should be no double counting, i.e. overlay should not be used for anything which is already provided by the model.
- Development of overlays should be independently validated by modelling experts and independently reviewed by auditors.
- Overlays should be adequately disclosed, a requirement by CBUAE, DIFC and ADGM.

For corporate entities using a provision matrix, the models are relatively simple, and data is comparatively easy to gather about the individual debtors. Therefore, corporate entities should avoid using any post model adjustments, unless it is used for forward looking macroeconomic adjustments.

Conclusion

In one of its recent articles, the World Economic Forum surveyed over 50 economists, asking for their predictions for economic recovery post COVID-19. The economists predicted different scenarios of recovery, i.e. whether it will be 'V' shape recovery, 'U' shape, 'W' shape, 'L' shape or some even predicted a 'tick mark' shape recovery. The recovery shape will vary country-to-country, while the 'U' shape is considered to be the base-case scenario, the 'V' shape is considered to be the best-case outcome when a growth plunge is followed by an equally sharp recovery, as fiscal and monetary stimulus could aid an equally swift rebound.

Whatever will be the actual scenario of the economic recovery, the financial reporting challenges in 2020 are here to stay until at least 2021. The easing of lockdown may reverse the economic slump but lingering unemployment and corporate bankruptcies will again create challenges for the application of IFRS 9. The key for finance professionals lies in early planning and identification of business and reporting challenges, including timely involvement of experts and auditors.

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