COVID-19 - how expected is that ECL?

Reporting Update

19 June 2020, 20RU-014

Highlights

- COVID-19 and ECLs – the uncertainty of it all
- Organisations will need to better understand their customer base to assess the impact of COVID-19
- Provisioning methodology and key inputs and assumptions will likely change
- Organisations will need to weigh up internal and external sources information (which can change rapidly) when estimating of ECLs

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COVID-19 and ECLs - the uncertainty of it all

Estimating ECLs in this current environment of high volatility and uncertainty requires significant judgement

The spread of COVID-19 has seen an unprecedented response by governments, regulators and numerous industry sectors in Australia and around the world. The Australian response to this pandemic has seen the closure of our international and state borders, significant restrictions on corporate Australia's ability to operate, volatility and instability in financial markets and significant slowdown and uncertainties in the Australian and global economies.

Impairment of assets, including financial assets, is a key area of focus for entities, stakeholders and regulators alike. The effects of COVID-19 will impact the assumptions about the collectability of the financial assets and hence the expected credit loss (ECLs). While ECLs are generally expected to increase for many organisations, by how much will depend on the specific facts and circumstances of the entity, and significant judgement is required. Organisations consider economists' recovery forecasts of different industries, the various government stimulus packages and the organisation's own responses to determine the various possible future scenarios which will form the basis of their assumptions in their estimation of ECL.

This Reporting Update includes a series of frequently asked questions as a guide on how organisations could approach the challenges inherent in ECL estimation during this time of uncertainty.

Scope

- Which assets must use the ECL approach to estimate recoverable amount?

Assessing the impact of COVID-19

- How does COVID-19 impact the use of historical data to estimate ECLs?
- What is the impact of COVID-19 on an organisation that has never recognised ECLs?
- What are examples of indicators that the collectability of receivables has deteriorated?
- What are some indicators that the recoverability of trade receivables may not have deteriorated as expected?

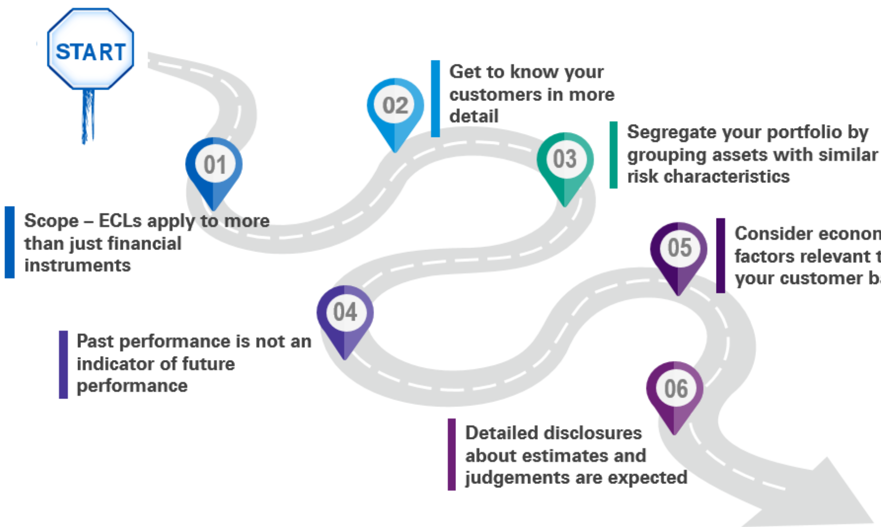
Impact on provisioning methodology

- How will COVID-19 impact the segmentation of an organisation's receivables portfolio?
- What are examples of when receivables are assessed on an individual basis?
- How will COVID-19 impact an organisation's write-off policy for receivables?
- What are some of the economic factors that may impact the estimation of ECL?
- What is the implication about the collectability of receivables if customers are on payment holidays?
- How does COVID-19 impact the assessment of a significant increase in credit risk (SICR) for receivables with a repayment term of more than 12 months?
- What are the different methods to recognise the impact of COVID-19 on ECL?
- Are ECLs updated for events which occur post reporting date?

Disclosures

- Are organisations expected to disclose estimates and judgements that form the basis of the measurement of expected credit losses?

Your ECL FAQ roadmap



ECLs are also used to assess the recoverability of lease receivables and contract assets

Scope

Which assets must use the ECL approach to estimate recoverable amount?

An entity applies the ECL approach to assess the recoverability of all financial assets carried at amortised cost which includes trade receivables and loan receivables. It is also used to estimate the impairment loss recognised in the income statement for debt instruments that are measured at Fair Value through Other Comprehensive Income. In addition, the ECL approach is also applied when assessing the recoverability of the following assets:

- Lease receivables (otherwise accounted for under AASB 16 *Leases*)
- Contract assets (otherwise accounted for under AASB 15 *Revenue from Contracts with Customers*).

Historical assumptions may be challenged

Assessing the impact of COVID-19

How does COVID-19 impact the use of historical data to estimate ECLs?

Many organisations use historical collection patterns to estimate ECLs (commonly known as provision for doubtful debts). ECLs are an unbiased, probability-weighted amount, estimated using reasonable and supportable information that is available without undue cost or effort at the reporting date. This includes information about past events, current conditions and forecasts of future economic conditions.

Given the unprecedented impact COVID-19 is having on various industries, historical collection patterns (past events) may no longer be a reliable indicator of the recoverability of an organisation's receivables portfolio.

Whilst historical loss information could be used as a starting point for estimating ECLs, organisations will need to assess whether, and by how much, they expect the COVID-19 pandemic to impact recoverability of their debtor balances based on the available information as at reporting date and adjust their ECLs accordingly.

What is the impact of COVID-19 on an organisation that has never recognised ECLs?

Some organisations may have never recognised a provision for ECLs on the basis that they have never suffered a loss.

For these organisations, consideration will need to be given as to whether this historical conclusion continues to hold true in the current environment. COVID-19 is having a pervasive impact on the global economy with very few organisations left untouched by its effects.

Organisations have to analyse how COVID-19 has impacted its customer base to determine whether COVID-19 will have a detrimental impact on the collectability of the related receivables portfolio. If the credit quality of the receivables portfolio is negatively impacted (or is expected to) then it may be necessary to recognise ECLs.

What are examples of indicators that the collectability of receivables has deteriorated?

Many non-lending organisations have typically focussed on assessing the recoverability of significantly aged debtors (for example, 120+ days). However given the impact of COVID-19 is unprecedented and the severity of the impact differs across various industries, organisations may need to analyse whether the recoverability of their debtors has deteriorated regardless of days past due. This requires a detailed understanding of the impact across its customer base.

Some indicators of a deterioration in collectability may include:

- Has there been a material increase in the receivables balance from prior year? If so, why did it increase, for example, is this because of an increase in sales or because of delays in receipts?
- Are customers still paying on time, started paying late or stopped paying altogether? Have debtor days relative to payment terms increased from the prior year?
- Have debtor days increased between February[1] (pre-COVID-19) and June (during COVID-19)?
- Have there been any defaults on amounts due from customers since the beginning of March?
- Have certain customers stopped making payments and have not made any additional orders?
- Are more customers being offered extended payment terms?
- Are aged debtors (e.g. 120+ days) approaching their customer limits? Has it been necessary to cut off credit offered to customers?

Where there are indicators that the recoverability of the asset portfolio has deteriorated, organisations need to consider how they will incorporate new information about the impact of COVID-19 into their determination of the expected credit losses.

What are some indicators that the recoverability of trade receivables may not have deteriorated as expected?

Some organisations may not see a deterioration in the collectability of their receivables portfolio, even though their customer base may have been impacted by the domestic and global lockdown restrictions. Further analysis may need to be performed to explain to your stakeholders the reasons for this outcome. Some examples include:

- How critical is the organisation to its customer's operations? The more crucial an organisation's supply of goods or services is to their customer's operations, the more likely invoices outstanding at the reporting date will be collected.
- Is the customer's ability to service their debts being supported by Government stimulus or other temporary support measures (such as temporary rent reductions)? If this is the case, collectability of invoices outstanding at the reporting date may still be recoverable.

Organisations however, will need to continue to monitor the operations of their customer base. For example, the customer may be less likely to pay its invoices on a timely basis if its business tapers off. Similarly, collectability of invoices from customers supported by Government stimulus package may be negatively impacted when this support ends. Depending on the longer term impact, loss rates applied at the reporting date could increase further in subsequent reporting periods.

[1] Note: February was prior to any significant impacts emerging in Australia. However, depending on a debtor's industry, you may need to consider an earlier time i.e. if sell into China, overseas travel related etc.)

Impact on provisioning methodology

How will COVID-19 impact the segmentation of an organisation's receivables portfolio?

Organisations can measure ECLs on a collective group basis, so long as the receivables are segmented based on shared credit risk characteristics.

Basis for segmentation may need to change

Organisations may have segmented their portfolio to capture the historical credit loss experience for different types of customers in prior periods. However, as the impact of COVID-19 on different industries is unprecedented, the segmentation applied in previous periods may no longer be appropriate and may require changes.

Understanding a customer's credit risk is a multifaceted process. For example, the credit risk of a customer may depend on a combination of the following:

- Customer type and size – an entity vs an individual, multinational corporations vs small to medium businesses
- Industry – hospitality and the arts versus supermarkets and health
- Geographic region – tourism-based economy versus manufacturing or in a different jurisdiction subject to its own lockdown laws
- The impact on the supply chain due to border restrictions and the flow-on implications on the operations of the customer; and/or
- Occupation and employment status – Where the customer base comprises individuals, for example, casual employees in the retail sector versus permanent employees in the healthcare sector.

In other cases, the extent of how critical the entity is to its customer's supply chain may differentiate the risk profile. The more crucial an entity's product is to their customer's operations, the more likely invoices outstanding at the reporting date will be collected compared to another customer who has multiple revenue streams and the entity is supplying to one of its smaller revenue streams.

What are examples of when receivables are assessed on an individual basis?

Organisations can measure ECL on a collective group basis, so long as the receivables are segmented based on shared credit risk characteristics. Consistent with this guidance, receivables that may already be in default or where there may be indicators that the asset is already impaired should be assessed separately. Depending on the amount outstanding, the ECL on these receivables may need to be assessed on an individual basis.

ECLs for amounts that are large in comparison to others in the portfolio may also be assessed on an individual basis. The size of a receivable may be an indicator that it has different credit risk characteristics compared to others.

How will COVID-19 impact an organisation's write-off policy for receivables?

Many organisations apply a blanket write off policy for portfolios of assets with small balances and similar risk profiles.

As a result of COVID-19, organisations may segment their portfolios into different sub-groups taking into consideration how COVID-19 has impacted their customer base across the various industries. Organisations may now apply a specific write-off policy to each sub-group of receivables. For example, the likelihood of a swift recovery for a manufacturing company whose operation is impacted by supply chain interruption may be lower than another manufacturing company not dependent on parts from overseas.

Take another example where an entity that provides a 90 days payment term had a blanket policy of writing off receivables when they reach 180 days past due. Due to COVID-19, it is now offering extended payment terms of 180 days to eligible customers.

In this scenario, the organisation's blanket write-off policy may not be appropriate as invoices that are 180 days past the extended due date would have previously been considered to be 270 days past due. Management may need to consider the collectability of receivables of this group separately.

What are some of the economic factors that may impact the estimation of ECL?

To determine ECL in the current environment, organisations may have to make assumptions and judgements about the period of downturn, the timing and rate of recovery and how these impact the different industries of their customer base. Organisations consider these factors to assess whether the amount outstanding at reporting date is recoverable. These are inputs to forming an estimate of the ECL.

External economic information and government policy will also need to be factored in

These economic assumptions should also be consistent with those used for other purposes, such as cash flow forecasts for assessing impairment of non-financial assets. They should be based on reasonable and supportable information available at the reporting date and not be overly optimistic nor overly pessimistic.

As COVID-19 impacts various industries in different ways, there is no "one size fits all" approach. However, there are some common considerations of economic factors that may impact your customer base:

Unemployment rates	Consider whether there is a general correlation between the level of employment and debtor recoverability • For individual debtors – are they employed in specific industries or sectors that have seen significant increases in unemployment? • For business debtors – how sensitive is their operation to unemployment levels?
Industry outlooks	Consider the potential outlooks for the industries relevant to your customer base • Are you exposed to industries that have been significantly impacted by the pandemic? • How quickly are those industries expected to "bounce back"? • Is there an expectation that they will never recover and may go out of business permanently (many already have)?
Virus containment measures and changes in level of restrictions	Consider the impact of various Governments lockdown laws • What is the impact of the restrictions on your customers and how and when do you expect these restrictions will be eased? • What does recovery look like for your customers, for example, how quickly will it bounce back?
Impact of government stimulus	Consider the impact of various Governments stimulus packages • Are your customers eligible to participate in these programs? If so, what is the impact on their solvency and the ability to pay short and longer term debts? • If your customers are reliant on relief measures – what will happen once the relief ends?

What is the implication about the collectability of receivables if customers are on payment holidays?

Many organisations offer payment holidays to their customers due to the impact of COVID-19. Organisations will need to consider whether there is a change in the credit risk profile of customers who are on extended payment terms. Provision for doubtful debt (ECL) will increase if, for example, customers are expected to continue to have longer term liquidity constraints beyond the payment terms.

However, organisations should not automatically assume there is an increase in credit risk if customers apply for payment holidays. It depends on the reasons for the payment holidays including whether it is just a short term liquidity constraint or customers taking an opportunity to preserve cash. It also depends on whether there is collateral and whether the value of the collateral is sufficient to offset the amount receivable.

How does COVID-19 impact the assessment of a significant increase in credit risk (SICR) for receivables with a repayment term of more than 12 months?

SICR is the based on the likelihood of a default arising over the lifetime of the receivables and is a concept applicable to longer term receivables. Therefore although COVID-19 may negatively impact the liquidity and profitability of borrowers, analysis should be performed to understand whether the impact is short term or longer term. Depending on the organisation's policy, there may be a SICR if the borrower is expected to continue to have longer term liquidity or solvency issues. It is a very judgemental assessment and will depend on, for example, the organisation's broader views on the macroeconomic impact of COVID-19 and how this might impact on the borrower's' operations and accordingly its likelihood of default.

What are the different methods to recognise the impact of COVID-19 on ECL?

Some organisations may apply a provision matrix where loss rates are attributable to receivables in different buckets to determine ECL on its receivables portfolio. It might look something like this:

	Current	0 – 30	31 – 60	61 – 90	91 – 180	180+
Receivables	180,000	201,500	243,000	130,000	157,000	36,000
Loss rate – 30 Jun 19	*0.5%*	*1%*	*3%*	*8%*	*19%*	*100%*
Loss rate – 30 Jun 20	**?%**	**?%**	**?%**	**?%**	**?%**	**100%**

In updating the ECL for the impacts of current economic conditions, entities may apply a range of methods including:

1. Updating the loss rates – for example by incorporating more recent loss information or by applying a scaling factor, or
2. Developing an overlay model to estimate the impact of COVID-19 and add this amount to the loss estimate produced by the existing model.

Are ECLs updated for events which occur post reporting date?

Consider the effect of post reporting date information

It depends. ECLs are measured at each reporting date based on all reasonable and supportable information available at that date without undue cost and effort.

No adjustments are made for events occurring after the reporting date unless the event indicates that there was a failure to consider appropriately all information that was reasonably available at the reporting date. To determine whether an event is an adjusting event, entities should consider whether those assumptions could be reasonably expected to be made as at reporting date.

For example, an entity supplies to restaurants. If the restaurants are impacted by the "one person per 4 square meter" rule and there is a public expectation at 30 June 2020 that this government restriction will be lifted in September 2020, this information should be factored in the estimation of the collectability of the receivables as at 30 June 2020. If it is announced in late July 2020 that this restriction will not be lifted for the foreseeable future, the entity *does not* adjust its estimation.

Significant judgement may be involved in assessing whether information available after reporting date indicates that the circumstances or assumptions should have been reasonably expected at reporting date.

Organisations are required to disclose material non-adjusting subsequent events in the financial report, including the nature of such events and where possible an estimate of their financial effect, or state that such an estimate cannot be made.

Disclosures

Are organisations expected to disclose estimates and judgements that form the basis of the measurement of expected credit losses?

Given the level of uncertainty and volatility due to COVID-19, organisations are expected to disclose assumptions and judgements applied in the measurement of ECLs.

Detailed disclosures about major sources of estimation uncertainty, the basis of assumptions and judgements made, and the sensitivity of the amount of expected credit losses to those assumptions are expected.

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