Covid Impacts on Accounting Standards

by Wayne Bartlett

Financial fallout of the pandemic causes Standard-setters to focus on IFRS 9

It's extremely unlikely that anyone reading this article has been unaffected by the global Covid-19 pandemic. Whether it be directly on the health front or indirectly on the financial fallout of the pandemic and the social interaction restrictions posed by lockdowns, there can be few people on the planet who haven't suffered consequences of one sort or another – even Antarctica has not been immune.

Financial reporting Standards have not been unaffected either. The pandemic poses challenges for those who set the Standards. Changes to the Standards are typically the work of years, involving extensive consultation and a chain of discussion papers and exposure drafts before finally a new or updated Standard is issued. But the generally glacial pace of change does not lend itself to rapid amendments. Yet the extreme nature of the pandemic, perhaps a once in a century event, inevitably creates tensions regarding Standards which have been set with a steady-state environment in mind. This has led to some unusually quick interventions by Standard-setters. One example of this concerned the treatment of rent concessions accounted for using IFRS 16, Leases. Another, the subject of this article, has led to some specific guidance being issued around the treatment of Expected Credit Losses (ECLs) under IFRS 9, Financial Instruments.

IFRS 9 and expected credit losses

In many ways, IFRS 9 is a unique Standard. It has an interesting and convoluted history. The global financial crisis of 2008-9 created a good deal of consternation amongst not just Standard-setters but also those who use financial statements, especially investors. The valuation of financial instruments, 'mark to market' as it was known, became a very controversial issue. It resulted in one of those rare occasions when accounting Standards made the front page of the non-financial press.

In the aftermath of that previous crisis, IFRS 9 slowly emerged in its current form.

The uniqueness of the Standard is partly in the way that it was developed, by instalments. In part this is due to the complex nature of the subject matter which covers a whole host of issues including very complicated ones such as the accounting treatment of hedging transactions. One of the more recent updates to IFRS 9 which appeared in 2018 involved the treatment of ECLs. It has had a particular impact on the banking sector.

Effectively what IFRS 9 was doing with regard to ECLs was to set out an impairment model and a methodology for expected credit losses involving financial instruments. However, it has impacts beyond just the banks: a simple trade receivable is also a financial instrument and potentially subject to expected credit losses too.

Basically, an expected credit loss is an estimation of how exposed to loss a financial instrument is. As such instruments are inherently subject to a risk of ultimate non-payment of the sums involved (which may be a partial loss of value or a total loss) then an element of prudence is required in terms of the accounting treatment of the items concerned, hence the rules included in IFRS 9.

In March 2020, information was released to clarify the use of the ECL approach in the pandemic environment (see https://www.ifrs.org/content/dam/ifrs/supporting-implementation/ifrs-9/ifrs-9-ecl-and-coronavirus.pdf). The press release accompanying this noted that this did not change the content of IFRS 9 but related to its practical implementation. It noted that the calculation of ECLs was challenging given the uncertainties of the pandemic and its fallout. However, it was important to make use of all available information, historic, current and forward-looking, when assessing them. Underlying the issue is whether to use expected losses in the next financial period, which would be the case with low-risk financial instruments, or lifetime losses which would be the case in higher-risk situations as an assessment of the likely impairment. Lifetime losses could increase the level of ECL impairments assessed and impact on the losses reported in the financial statements of affected businesses. Because of the pandemic, entities may need to reassess their pre-existing approaches to making such assessments

IAASA and IFRS 9

In January 2022, the Financial Reporting Supervision Unit of the Irish Auditing and Accounting Supervisory Authority (IAASA) issued an information note on the application of IFRS 9 (this can be found at https://www.iaasa.ie/getmedia/7278a198-493b-4b71-bd77-66fd46f3bb79/Info-Note-Applying-IFRS-9-January-2022.pdf). This followed on from a statement released by the European Securities and Markets Authority (ESMA) in March 2020, right back at the very beginning of the pandemic (which in some ways seems another world now). This highlighted the need for well-developed disclosures around banks' exposures to the pandemic with special regard to ECLs. Areas where particular attention was required was with regard to changes in ECL allowances when compared to previous periods and also the impact of government relief measures as a mitigating factor. Details of risk concentrations are also of enhanced importance.

Underpinning this concern is the very real impact that the pandemic potentially has on the risk profile of banks in particular. The dramatic financial consequences of the pandemic have, for some entities, led to an increased possibility of economic failure. This has clear and present dangers for banks who have entered into financial arrangements with them (and for that matter also on more everyday transactions such as trade receivables which of course involve a whole host of organisations other than banks). The collapse of businesses due to the pandemic has obvious knock-on effects for the repayment of such debts to banks and others.

The information note issued by IAASA looks at four banks in particular, all of them listed on the main market of Euronext Dublin. They are AIB Group plc (AIB), Bank of Ireland Group plc (BoI), Permanent TSB Group Holdings plc (PTSB) and Bank of Cyprus Holdings plc (BoCH). By aggregating the ECL impacts included in the financial statements of the four banks, the following observations were made by IAASA:

- the rapid and significant increase in the ECL impairment charge in the income statement at the start of the pandemic relative to pre-Covid-19 ECL impairment charges (consistent with an expected loss model which would indicate the need for higher impairment estimates due to the potential fallout of the pandemic)
- a significant reduction in ECL impairment charges (or writebacks) recognised in the income statements of banks during the HY 2021

- a rapid increase in the level of ECL post-model adjustments recognised by the banks since the start of the Covid-19 pandemic
- material ECL post-model adjustments continuing to be recognised by three of the four banks at 30 June 2021.

IAASA have concluded that the level of ECL post-model adjustments suggests that, at the reporting dates, banks had not yet fully embedded significant levels of uncertainty into their ECL models for reasons that are specific to each bank and its particular circumstances. That is inevitably a generalised comment but does suggest that there are (unsurprisingly) difficulties in making impairment estimates accurately in such an uncertain situation.

I would argue that this difficulty is inherently unavoidable at the best of times. Any impairment is hard to estimate with total confidence: after all we are talking about making estimates of what is going to happen in the future. In the absence of a state-of-the art crystal ball this is not easy. That said, the massive uncertainties created by the pandemic significantly magnify this inherent difficulty.

Implications for accountants and auditors

These collective comments are an important reminder to many of the need to take extra care regarding ECLs as a result of the pandemic and its ongoing repercussions.

They also form part of a bigger picture. It's easy to become purely focussed on financial reporting during a conversation such as this but an increased level of ECL exposure has potential repercussions on wider financial management for businesses too.

A major default from a material debtor could well have knock-on effects for those who were relying on them too. It therefore is in all our interests to focus on this as a heightened risk area in the current environment. This applies not just to banks, which the IAASA guidance is primarily aimed at, but any business that has significant receivables on their balance sheets too.

For accountants, attention to ECLs has several dimensions to consider. One of them is of course financial reporting and the need to ensure that disclosures are comprehensive and that valuations included in balance sheets are reliable. From a financial management viewpoint, and as an adjunct to these financial reporting considerations, closer monitoring of such items is key. Some important questions need to be answered, such as are there indications of changes in payment patterns, are payments which have fallen due remaining unpaid, are customers seeking changes to payment terms for example? This has clear implications for financial stability, profitability and cash flow.

These considerations extend to auditors too. Auditors have come under fire frequently in the past for failing to spot increased risk factors. Whether these observations have merit or not, it would be potentially unwise not to focus on possible increases to ECL risk when auditing businesses which have a high balance sheet exposure to such. Financial statements must of course fairly represent the big picture of the financial position, performance and cash flows of a business and inadequate ECL accounting raises potential issues for all of these. It would be prudent for auditors to take such considerations into account when planning, executing and reporting on an engagement, focusing on both balance sheet values for items affected by ECLs and also the accompanying disclosures.

Wayne Bartlett,
FCCA, MBA

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