

PUBLIC STATEMENT

Accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9

ESMA is issuing this statement in order to promote consistent application of International Financial Reporting Standards (IFRS) in the European Union (EU) and avoid divergence in practice on the application of IFRS 9 *Financial Instruments* in the specific context of the COVID-19 outbreak. The Statement addresses in particular the accounting implications of the measures taken or proposed by national governments and EU bodies to address the adverse systemic economic impact of the COVID-19.

In ESMA's view, the principles-based nature of IFRS 9 includes sufficient flexibility to faithfully reflect the specific circumstances of the COVID-19 outbreak and the associated public policy measures. Issuers and their auditors should take this Public Statement into due consideration. ESMA will continue monitoring issuers' practices in relation to IFRS 9 and in particular as regards the application of judgement in the current context.

Whilst this statement addresses solely financial reporting aspects, ESMA has coordinated with the European Banking Authority (EBA) which issued a [statement](#) on the prudential framework in light of COVID-19 measures on 25 March 2020. Both statements are consistent as regards financial reporting. Furthermore, before publishing this Statement, ESMA actively engaged with the services of the European Commission to coordinate the response in this area. Finally, for further information on the audit of financial statements in the context of COVID-19, please refer to the [statement](#) published by the CEAOB on 25 March 2020.

Background

In light of the spread of COVID-19 across the globe, a variety of measures have been, and continue to be, taken by European governments to prevent the transmission of the virus along with economic support and relief measures aimed at addressing the economic consequences of the outbreak on individuals, households and businesses. Such relief measures include, but are not limited to, moratoria on repayment of loans, overdraft facilities and mortgages, loan guarantees as well as other forms of business support targeted at individual firms or specific industries (e.g. for liquidity purposes).

ESMA also notes that issuers might be providing measures on a voluntary basis to borrowers in the context of COVID-19. These might take the form of renegotiations, rollovers or rescheduling of cash-flows that might or might not have an impact on the net present value of these cash-flows.

While these measures can take a variety of forms, issuers should carefully consider the related impact on financial reporting, in particular with respect to the requirements of IFRS 9.

Assessing these impacts requires an assessment of the specific conditions and circumstances that allow issuers to distinguish between measures that have an impact on the credit risk over the expected life of financial assets and those which address temporary liquidity constraints of borrowers. Consequently, ESMA is issuing this statement to address specific aspects related to the application of IFRS 9 under these circumstances in the upcoming periodic information of European issuers.

Accounting implications

Accounting for the modifications resulting from the introduction of the support measures

ESMA considers that issuers should carefully assess the impact of the economic support and relief measures on recognised financial instruments and their conditions. This includes the assessment of whether such measures result in modification of the financial assets and whether modifications lead to their derecognition.

In the absence of specific guidance in IFRS 9, issuers develop their accounting policies in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*¹ and IFRS 9 principles. Determining whether derecognition occurs depends on whether the modification of the terms of the instrument is considered substantial or not.

ESMA notes that such assessment should include both qualitative and quantitative criteria and, especially given the situation, might be subject to significant judgement. In light of the current circumstances, ESMA considers that if the support measures provide temporary relief to debtors affected by the COVID-19 outbreak and the net economic value of the loan is not significantly affected the modification would be unlikely to be considered as substantial.

ESMA also highlights the need for issuers to disclose (i) their accounting policy for determining when a modification is substantial if relevant to an understanding of their financial statements, and (ii) judgements made that have the most significant effect on the amounts recognised in their financial statements. The considerations set-out below are especially relevant where the financial asset is not derecognised.

Assessment of significant increase in credit risk (SICR)

IFRS 9 requires issuers to assess at each reporting date whether the credit risk of a financial instrument has increased significantly since its initial recognition. ESMA notes that assessing whether there is a SICR is a holistic assessment of a number of quantitative and qualitative indicators [IFRS 9, paragraph B5.5.17] and should capture the changes in the lifetime risk of default, i.e. over the entire expected life of the instrument.

ESMA also notes that many governments are establishing economic support programs for impacted businesses or industries. While the form of the support programs vary, ESMA considers that, given the fact that these programs are designed to mitigate the adverse impact

¹ As per IFRIC Update September 2012: Agenda Decision: Derecognition of financial instruments upon modification

of COVID-19 and related economic consequences, when these support programs impact (i.e. reduce) the lifetime risk of default on a financial instrument they should be considered in the assessment of the SICR of that financial instrument.

In particular, ESMA notes that the measures taken in the context of the COVID-19 outbreak which permit, require or encourage suspension or delays in payments, should not be regarded as automatically having a one-to-one impact on the assessment of whether loans have suffered a SICR. Therefore, a moratorium under these circumstances should not in itself be considered as an automatic trigger of SICR. ESMA would like to highlight that, in the context of the SICR assessment, an analysis is necessary of the conditions under which these measures are implemented.

ESMA notes that if reasonable and supportable information that is more forward-looking than information on the past due status of the concerned exposures is not available without undue cost or effort (either on an individual or a collective basis), issuers may use past due information to determine whether there have been significant increases in credit risk since initial recognition [IFRS 9, paragraph 5.5.11]. However, it is noted that, while there is a rebuttable presumption that payment defaults of more than 30 days provide evidence of a significant increase in credit risk in applying IFRS 9, this presumption can be rebutted [IFRS 9, paragraph B5.5.20]. ESMA reminds issuers to carefully consider whether the specific circumstances related to the COVID-19 outbreak and associated economic support and relief measures provided in individual circumstances, constitute sufficient justification to rebut this presumption and disclose the judgement in this respect.

It is relevant to note that in case issuers encounter difficulties in identifying the COVID-19 effects at instrument level, it may be necessary to perform the assessment on a collective basis (i.e. on a group or sub-group of financial instruments) [IFRS 9 paragraphs B5.5.1-B5.5.5]. The Standard also provides two examples (IFRS 9, IE38 and IE39) of how to implement such collective staging assessment.

Furthermore, when relief (forbearance) measures are provided to borrowers by issuers, ESMA notes that these measures should be analysed taking into account all the facts and circumstances, in order to distinguish, for example, whether the credit risk on the financial instrument has significantly increased or whether the borrower is only experiencing a temporary liquidity constraint and there has not been a significant increase in credit risk.

Expected Credit Loss estimation

The Expected Credit Loss (ECL) model in IFRS 9 requires issuers to measure expected losses and consider forward-looking information, by reflecting “*an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes*” and taking into account “*reasonable and supportable information that is available without undue cost or effort at that date about past events, current conditions and forecasts of future economic conditions*” [IFRS 9, paragraph 5.5.17].

Issuers should assess the extent to which, amongst other facts, the high degree of uncertainty and any sudden changes in the short-term economic outlook are expected to result in impacts

over the entire expected life of the financial instrument. Such considerations are integral to the functioning of the ECL model under IFRS 9 and ESMA highlights that the Standard does not envisage any automatism as to how such contextual factors should impact on the loan loss provisioning. In particular, given the scarcity of available and reliable information in the current context, issuers will face problems in generating reasonable and supportable short-term economic forecasts.

In this context, ESMA highlights the recent ECB supervisory measures taken in reaction to the coronavirus in this area² (i.e. the recommendation that, given the current state of uncertainty linked to the COVID-19 outbreak, within the framework provided by IFRS, issuers give a greater weight to long-term stable outlook as evidenced by past experience and take into account the relief measures granted by public authorities – such as payment moratoria).

Finally, in ESMA's view, when making forecasts, issuers should consider the nature of this economic shock (i.e. whether the COVID-19 effect is expected to be temporary) and the impact that the economic support and relief measures (including debt moratoria) will have on the credit risk over the expected life of the instruments, which include, depending on the instruments' maturities, longer-term estimates.

Public guarantees on issuers' exposures

Member States are also envisaging to provide public guarantees on issuers' exposures. These measures may have different features but they share the fundamental one of ensuring partial or full recovery of the amounts relating to the impacted financial instruments.

ESMA notes that the SICR assessment is focused on the changes in the lifetime risk of default for each exposure compared to this risk at initial recognition, regardless of whether a loss is expected to be recognised or not. This means that the value of collateral or the occurrence of any guarantee does not affect the SICR assessment.

However, ESMA highlights that the existence of such credit enhancements might have an impact on the ECL measurement itself, depending on whether they are considered an integral part of the contractual terms or not and whether they are recognised separately by the issuer.³ In measuring ECL, an issuer should include the cash flows from the realisation of collateral and other credit enhancement that (i) are an integral part of the contractual terms of the loan and (ii) are not recognised separately [IFRS 9, paragraph B5.5.55]. ESMA also notes that in December 2015, the Transition Resource Group⁴ for Impairment observed that credit enhancements included in the measurement of expected credit losses should not be limited to those that are explicitly part of the contractual terms. This is the case, in particular, when the public guarantee is provided in conjunction with broadly applicable *ex-lege* debt moratoria or economic support and relief measures.

² https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320_FAQs--a4ac38e3ef.en.html

³ IFRIC March 2019

⁴ Limited-life group established by the IASB with the aim of providing support for the implementation of the expected credit loss requirements in IFRS 9 Financial Instruments in advance of the standard's effective date.

ESMA is of the view that the assessment of whether the public guarantee can be considered an integral part of the contractual terms or not may involve judgement. ESMA highlights the importance that such judgements, to the extent significant, be clearly disclosed in their financial statements.

Transparency

ESMA would like to stress the importance of providing all relevant disclosures related to the actual and potential impacts of COVID-19 in order to comply with the requirements of IFRS 7 *Financial Instruments: Disclosures*. In particular, disclosures shall enable users of financial statements to evaluate the ECL recorded and to understand the assumptions and judgements made in their estimate. This includes, inter alia, judgements made on how and the extent to which the effect of COVID-19 and related support measures have been factored into the assessment of SICR and ECL, as well as the use of forward-looking information.

Where interim financial statements are concerned, as they provide an update on the latest set of annual financial statements [IAS 34, paragraph 6], ESMA is of the view that, given the magnitude of the latest economic changes, sufficient disclosure needs to be provided in the interim financial statements for investors to understand the significant events and transactions occurring since the end of the annual financial reporting period [IAS 34, paragraphs 15B and 16A].

Furthermore, in line with the requirements of IFRS 7 and IAS 1 *Presentation of Financial Statements*, ESMA is of the view that issuers should provide any additional information to enable users of financial statements to understand the overall impact of COVID-19 on the financial position and performance of the issuer. This is particularly important for areas in which IFRS require that significant judgement is applied, which might include also other areas of financial reporting.

ESMA reminds issuers that they are expected to disclose the principal risks and uncertainties that they face because of the COVID-19 outbreak in their management reports.

Finally, ESMA reminds issuers of their obligations as regards the disclosure, as soon as possible, of any relevant significant information concerning the impacts of COVID-19 on their fundamentals, prospects or financial situation in accordance with their transparency obligations under the Market Abuse Regulation.