Accounting implications of coronavirus (COVID-19)

Points of reference for preparers of financial reports

Introduction

The recent COVID-19 outbreak has caused extensive disruptions to the entire global economy. In Australia, additional precautions such as travel and transport restrictions, quarantine measures, and limitations of operating activities of businesses have been enforced, with the breadth of these limitations expanding over time.

Due to the rapid evolution of the situation, it is difficult to predict the full economic impact of the pandemic. This document seeks to provide some insight on the key accounting implications that management will need to consider for periods ending subsequent to 31 December 2019 (including interim periods).

The following topics are addressed in this document:

1. Subsequent events;
2. Going concern, including the basis of preparation;
3. Impairment of assets, including goodwill;
4. Revenue;
5. Allowance for expected credit losses;
6. Fair value measurement;
7. Government grants;
8. Lease Modifications;
9. Financial instrument modifications – debt instruments;
10. Financial instruments – counterparty risk;
11. Provisions;
12. Other considerations:
    a. Joint ventures and associates;
    b. Valuation of inventories;
    c. Deferred taxes;
    d. Borrowing costs;
    e. Insured events; and
    f. Hyperinflation.

1. Subsequent events

For entities reporting as of 31 December 2019, the outbreak of COVID-19 is a non-adjusting subsequent event – refer to TA Alert 2020-05 for detailed discussion. In brief, the outbreak does not impact expectations as of 31 December 2019 and therefore is not factored into impairment calculations or expected credit loss estimates. Despite this, it is required to be included in the entity's going concern analysis where that analysis is prepared subsequent to the outbreak occurring – for instance, for financial statements prepared for issuance subsequent to 31 March 2020 (AASB 110.15).

For entities with balance dates subsequent to the known outbreak of COVID-19, the events in question occur at least in-part during the reporting period, and thus the impacts must be included in estimates developed and judgements made by management. Determination must also be made as to whether information which becomes available subsequent to reporting date – for example, the closure of schools – is indicative of outcomes that could reasonably be estimated as impacting as of balance date, given the presence of the pandemic.

It would be appropriate for management to consider the following information which potentially became apparent subsequent to year-end when assessing the accuracy of their estimates and judgements made prior to the information becoming available:

- Closure of schools;
- Cessation of international travel;
- Closure of substantially all retail operations;
- Forecasts not being achieved;
- Interruptions in supply;
- Cessation of non-essential services;
- Customers entering administration; or
- Government support.

2. Going concern, including the basis of preparation

Entities are required to assess their ability to continue as a going concern and whether the going concern assumption is appropriate in accordance with AASB 101 *Presentation of Financial statements*. Auditors are required to audit this information and form an opinion by application of ASA 570 *Going Concern*.

Management's assessment of the going concern assumption requires all available information about future outcomes for a period of at least 12 months from the end of the reporting period be taken into account (AASB 101.26). This assessment must be performed up to the date on which the financial statements are issued and thus must include expectations of the impact of COVID-19 upon the entity (AASB 110.15). This contrasts with the auditor's obligation to consider the appropriateness of the going concern assumption through the period of the expected date of the next audit report (ASA 570.Aus13.2) – as a result, best practice would suggest that management extend their forecast to cover that period.

For an entity impacted by the COVID-19 outbreak, management is required to assess the appropriateness of preparing the financial statements on a going concern basis. Where management is aware of material uncertainties that cast doubt on the entity's ability to continue as a going concern, the entity should disclose that material uncertainty in the financial statements. Where these uncertainties are so pervasive that management determine that the entity is not a going concern, the financial statements must not be prepared on a going-concern basis, and clear statement of that fact should be made and the alternative basis on which these have been prepared explained.

Entities that have historically not exhibited indicators of risk relating to the going concern assumption may exhibit increased risk in the current environment. Management should assess the existence of risk related to going concern and ensure that appropriate controls are established to ensure appropriate conclusions are reached.

Examples of indications of uncertainty regarding the entity's ability to continue as a going concern include:

Investor support related:

- Cessation of support by related parties;
- Inability of related parties to guarantee support of the entity;
- Forecasts relying on the entity's ability to access additional equity funding, or perform successful capital raises;

Finance related

- Financiers calling debt;
- Refinancing required in the subsequent period;
- Breach of covenants;

Cash-cycle related

- Decreasing ability to collect accounts receivable;
- Customer defaults;
- Increasing working capital;
- Inability to meet obligations to taxing authority (e.g. ATO or state revenue offices);
- Deferral of superannuation contributions;

Operationally related

- Significant reductions in margin;
- Increase in onerous contracts or impairment of Right of Use Assets;
- Aggressive discounting;

Financial indicators

- Losses incurred;
- Negative operating cash flows;

3. Impairment of assets, including goodwill

AASB 136 *Impairment of Assets* requires an entity to assess other finite non-financial assets for impairment when impairment indicators exists, while goodwill, indefinite-lived intangible assets and intangible assets not yet ready for use are required to be tested for impairment at least every year.

Detailed examples of indicators of impairment are included in AASB 136.12. The most relevant indicators are included below – note that this list is not exhaustive. Given the prevalence of certain of these indicators, we encourage management to undertake impairment testing as appropriate.

External indicators

- Observable indicators of decrease in value;
- Significant changes with an adverse effect on the entity have taken place during the period in the economic environment in which the entity operates or in the market to which an asset is dedicated;
- The carrying amount of the net assets of the entity is more than its market capitalisation.

Internal indicators

- Assets becoming idle;
- Evidence that economic performance is worse than expected;
- Plans to dispose of an asset;
- Plans to restructure.

Due to the temporary interruption of operations and potential ongoing uncertainty, an immediate decline in demand and reduction of profitability can be expected. These declines must be included as key assumptions in ViU forecasts with clear, reasonable, and auditable assumptions included in the model. It is not reasonable, in the current environment, for most entities to forecast growth from the comparative period.

It is also likely, given the recent volatility of capital markets, that:

- Beta for the entity may increase (as a result of increased risk related to forecasts given increased uncertainty); and
- The indicated cost of equity may increase;

resulting in increases in the weighted average cost of capital and decreases in the net present value of future cash flows. Impairment is thus likely to be expected in many instances.

Where impairment results upon the application of the ViU model, the Fair Value less Costs of Disposal model must be considered.

Reference should be made to closed and completed transactions, while minimising reliance upon fire-sales of assets or asset groups that may have occurred. In the current environment, it may be difficult to determine a current fair value in the absence of arms-length transactions between willing parties.

As a reminder, the entities using a single predicted outcome approach should make adjustments to incorporate the risk associated with COVID-19. The associated risks could be either reflected in the cash flows or the discount rate while ensuring the long-term growth assumptions are appropriate.

No matter which approach is used (multiple probable outcome or single predicted outcome), management must ensure the outcome reflects the expected present value of future cash flows.

3a Impairment of long-lived assets

Individual long-lived assets should be assessed for impairment where indicators of impairment are identified. For certain assets, this may be best achieved by reference to the Cash Generating Unit that the asset operates within. For others, particularly where an observable Fair Value less Costs of Disposal exists, it may be appropriate to test for impairment at the asset level, notwithstanding a lack of independent cash inflows being able to be generated by the asset (AASB 136.22).

Classes of long-lived assets likely to be impacted include:

- Right-of-use lease assets;
- Property, plant and equipment;
- Intangible assets.

3b Other assets potentially subject to impairment

Entities may have assets that are subject to impairment testing that do not qualify as long-lived assets and are not financial assets. These assets should be assessed for impairment, particularly where these amounts reflect historic transactions with third parties where the creditworthiness of these third parties is now called into question. Examples include:

Security deposits held by third parties

What is the creditworthiness of the counterparty – is the deposit recoverable?

Prepayments

Does the counterparty retain its ability to provide the prepaid services? E.g. prepaid software maintenance.

4. Revenue

Entities are generally expecting to experience significant declines in revenue and decreases in progress of delivery of performance obligations for long-term contracts. These declines in revenue may arise from decreases in volume and changes in variable consideration (refer 4a). It is likely that, as a result of changes in the economic environment, customers will seek to modify contracts (refer 4b); it is also possible that the ability of customers to pay for goods may be called into question prior to delivery occurring. The entity may choose to transact in this situation notwithstanding the uncertainty (refer 4c). Contract assets recognised as revenue recognised in advance of invoicing may also be subject to additional realisation risk. Such contract assets are tested for impairment by application of the expected credit loss model defined by AASB 9 – refer Section 5.

4a Variable Consideration

Variable consideration is any consideration which is not fixed in the contract. Variable consideration changes can potentially impact the assumptions used in measuring revenue from goods or services which have already been delivered, especially where contracts contain:

- Penalties including liquidated damages;
- Performance bonuses (esp. time-based bonuses);
- Volume-based variable pricing;
- Price concessions;
- Unpriced change orders.

These factors are required to be adjusted at each reporting date – the impact of the above will thus be required to be included in revenue for each reporting date subsequent to 31 December 2019 (including 30 June 2020 year-ends); a significant reversal of revenue is possible as each of the above is remeasured which may, for a contract, result in negative revenue in the current reporting period.

Example

EnginCo, an entity with a 31 December year end, commenced a contract with CustomerCo in May 2018 involving the production of eight tractors. CustomerCo agreed to pay DevelopCo $1,000 upon delivery of each tractor, with a bonus of $2,000 if all tractors are delivered by 30 June 2020. At 31 December 2019, six tractors had been delivered, with the seventh nearing completion and the eighth on schedule for delivery 31 May 2020. On 31 March 2020, EnginCo ceased construction due to social distancing rules with seven tractors delivered. Assume
no contractual ability to terminate under force majeure. Assume also that point-in-time revenue recognition is appropriate.

As of 31 December 2019, EnginCo recognised the following revenue:

Delivery of 6 tractors ($1,000 x 6):	$6,000
Share of bonus ($2,000 x 6/8):	$1,500
Total revenue recognised:	$7,500

It was appropriate to recognise the share of performance bonus at 31 December 2019 – at that date, it was "**highly probable** that a significant reversal in the amount of cumulative revenue will not occur when the uncertainty associated is subsequently resolved" (AASB 15.56). Note that the hurdle is "highly probable" not "certain" – it may have been reasonable, at 31 December 2019, to not anticipate a pandemic.

For the half-year ended 30 June 2020, it is apparent that the performance bonus will not be received. As of 31 March 2020, the aggregate amount of revenue to be recognised is:

Delivery of 7 tractors ($1,000 x 7):	$7,000
Share of performance bonus	$0
Total revenue recognised:	$7,000

This results in a required reduction in revenue recognised of $500 – negative revenue results.

4b Contract modifications

Where a customer encounters financial difficulty or reduced demand, it may request a contract modification (AKA "change order", "variation" or "amendment") to alter the scope of the contract. If the scope of the contract decreases, or the scope increases but pricing does not change by the stand-alone selling price of that increase, contract modification accounting is applied (AASB 15.20).

If contract modification accounting is applied, the entity must apply the most appropriate of the following methods:

- Treating completion-to-date as a terminated contract, with unrecognised revenue and undelivered performance obligations being allocated to a "new" contract (AASB 15.21(a));
- If a performance obligation is partially satisfied, reassess revenue as if the modified contract was effective from the initial date of the contract and adjust revenue up or down, as appropriate, as of the date of the modified contract (AASB 15.21(b)); or
- • If appropriate, a combination of the two approaches (AASB 15.21(c)).

4c Revenue where significant uncertainty of receipt of payment exists

AASB 15 also requires an entity to recognise revenue from contracts only where the customer is expected to meet its obligations under the contract. Though management would continue to supply to the customer, revenue should only be recognised when it is probable that the customer will be able to pay the transaction price (AASB 15.9(e)). In such an instance, the entity should defer recognition of any revenue until collection becomes probable. The costs to fulfil the contract cannot be deferred and should be recognised as incurred as they are not 'expected to be recovered' (AASB 15.95(c)).

5. Allowance for expected credit losses

Financial assets which are not measured at fair value – either through profit or loss or other comprehensive income – (and Contract Assets created by the application of AASB 15) are required to be adjusted for impairment using the expected credit loss ("ECL") model defined in AASB 9 *Financial Instruments*. The ECL is calculated at the reporting date taking into account past, current, and forecast future economic conditions, with an expectation of losses to be incurred in future periods required to be accounted for at reporting date.

This approach applies to:

- Short Term Trade Receivables;
- Long Term Trade Receivables;
- Lease receivables;
- Loans receivable;
- Contract assets; and
- Other debt instruments measured using amortised cost and fair value through other comprehensive income (debt FVOCI).

For certain identified classes – Contract Assets and Short Term Trade Receivables – the simplified ECL model may be applied. For other classes, management is required to assess if the risk of default has increased significantly since initial recognition of the receivable – if so, the estimate of ECL is required to be measured using the "Lifetime ECL" model (sometimes referred to as "Stage 2") rather than the 12-month ECL model (referred to as "Stage 1").

The estimation of ECL will change depending on the impacts of the outbreak on different counterparties. For example:

- The risk of default will increase depending on the significance of impact to the counterparty;
- Assets pledged as security may be of decreased fair value given market conditions; and
- The potential for loss will increase even where high-quality security exists.

The implications of COVID-19 may differ depending on the entity specific situation and methodology in assessing ECL.

This assessment should be made *by reference to only that information regarding conditions at the reporting date.* The application of hindsight is not consistent with the ECL models.

6. Fair value measurement

The objective of AASB 13 *Fair Value Measurement* is to reflect the fair value of the asset or liability being measured by imitating conditions as of the reporting date – and therefore reflects fair value as of the date of measurement, not as of a date in the future. Fair value of an asset and liability is determined in accordance with the relevant accounting standards, but, when applying AASB 13 (as required by multiple other standards), methodologies are limited to application of the following models: Market, Income, and Cost. The Market and Income models are most significantly impacted by the impact of the economic environment.

6a Market Model

Where a Market model is selected, the quoted market price and observable market conditions must be used.

If observable market conditions aren't available as inputs, unobservable inputs should be used to measure fair value, however, this does not change the objective of the standard.

Following the above objective, facts and circumstances arising after reporting date may provide useful insights on the assumptions used in estimating the fair value at the reporting date. Adjustment is only made to the extent of evidence at the reporting date. Hence, changes in the market prices after reporting date are not reflected in the valuation.

6b Income Model

Similar to a Value in Use model defined by AASB 136 (refer Section 3), the Income Model takes into consideration forecast future cash flows of an operation. Such forecasts are subject to significant uncertainty – refer to Section 3 for further detailed discussion.

7.Government grants

7a For-profit entities

Transactions involving government grants received by for-profit entities are accounted for by applying AASB 120 *Government Grants*. In summary, Government Grants are "assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity" (AASB 120.3). Currently proposed (though not enacted) examples of grants relating to the economic environment include:

- Subsidised wages;
- Forgiveness of payroll-related liabilities, such as unpaid employee taxes withheld;
- Direct cash grants;
- Finance provided by government at below-market rates (AASB 120.10A); and
- Rent assistance.

The following stimulus measures may not be Government Grants:

- Payroll tax moratoriums and refunds;
- Income tax regulation changes; and
- Debt guarantees provided by the government

For-profit entities: Grants related to income

Where Government Grants are received, typically the grant is recognised as income at the date at which it is reasonably assured that (a) the entity will comply with the conditions attached; and (b) the grants will be received. The income is recognised within profit or loss as the conditions are complied with – that is, for subsidised wages, this will be the period of service for wages, while subsidised construction may related to the period of construction, or more commonly the period that depreciation is subsequently booked. Generally, the fair value of the consideration is directly observable – for instance, cash received. For finance provided at below-market rates, the fair value of the government grant is determined by reference to the relative fair value of the debt when fair valued in the absence of the government grant.

For a transaction to be classified as a government grant, the grantor must be a government entity. Certain forms of government grants given to lessors for the benefit of lessees have been proposed, including land tax holidays or refunds, which may or may not be directed by a government body. Where a government body directs a benefit (such as refunded land tax) for the benefit of individual lessees (e.g. as rent abatement), it is reasonable that the grant is being received from the government and falls within the scope of AASB 120.

Where the benefit is being directed to be used for lessees as a class, such that the lessor may direct the benefit, the benefit, in the hands of the lessee, does not fall within the scope of AASB 120 – it was received due to their relationship with the lessor rather than as a result of a government grant. In such an instance, lease modification accounting may apply.

For-profit entities: Grants related to assets

Although currently not proposed, there is potential that entities will receive grants related to the purchase, acquisition or construction of assets. As with grants related to income, paragraph 12 applies: "Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate." This paragraph, and paragraphs following, allow for such a grant to either:

a) Reduce the carrying value of the asset being acquired; or
b) Be recognised as deferred income and systematically amortised over a period matching the useful life of the acquired asset.

Approach a provides simpler accounting, while approach b clearly demonstrates the relative benefit received and historical cost of the acquired asset. Either presentation is appropriate.

Presentation

Grants related to income – that is, those that are not specifically related to an asset – are required to be presented as a part of profit or loss, either separately or under a general heading such as 'Other income'. Alternatively, they are deducted in reporting the related expense (AASB 120.29).

Note that grants are **not** revenue and should not be presented as such.

There is thus a policy decision available to the entity as to how the grant is presented on the face of the profit-or loss. The preference within the Financial Reporting Advisory team is that the grants be presented separately on the profit or loss and not netted against the related expense. Disclosure of the effect of the grant on any item of income or expense which is required to be separately disclosed is usually appropriate.

Grants related to assets are presented on the balance sheet in accordance with the section "For-profit entities: Grants related to assets", above. The profit or loss impact is presented in a manner consistent with Grants related to income.

7b Not-for-profit entities

AASB 1057 *Application of Australian Accounting Standards* paragraph 8 limits the application of AASB 120 to for-profit entities. AASB 1058 is thus applied as required by paragraph 20A of that standard to account for government grants.

Given the nature of the grants being provided, it is generally unlikely that the grants received will have a sufficiently specific performance obligation associated with them – and, as such, will not be accounted for by applying AASB 15.

The transactions may, therefore, be required to be recognised immediately in profit or loss by application of paragraph 10 of AASB 1058.

Where grants received relate to an asset – for example, the acquisition or construction of a non-financial asset to be controlled by the entity – paragraphs 15 to 17 apply. In contrast to AASB 120, these paragraphs require that, subject to criteria, income be recognised as the entity fulfil the obligation to acquire or construct the non-financial asset.

Presentation

As with for-profit entities, this grant is recognised as income and not revenue. Paragraph 10 states "…an entity shall recognise income immediately…", the implication of which being that a net presentation is not appropriate to not-for-profit entities.

Example: Government Grants

RetailCo was significantly adversely impacted by decreases in foot-traffic and closed its stores on 15 March 2020. Economic and regulatory circumstances changed on 30 June 2020 such that RetailCo wished to reopen its stores, however the significant period of time with no cash inflow resulted in insufficient working capital to meet its lease obligations.

RetailCo received a 2 year interest free loan from the federal government of $1,000 secured over the assets of RetailCo with repayment due in full at the end of the loan term. RetailCo has determined that in an arms-length transaction, a counterparty would demand an interest rate of 10% per annum as simple interest, payable in arrears.

The fair value of the debt is thus determined as the net present value of the debt:

NPV of cash flows: $1,000/1.10 *(Excel formula: =NPV(10%,0,1000*

$826.45 Fair value of grant: $173.55

The fair value of the grant is recognised either as income upon receipt of the grant or over the term of the loan, whichever is appropriate.

8. Lease modifications

Leases are an area of focus by the IASB and AASB. The IASB has issued guidance and educational material which will be publicly available shortly. We will update this guide once available. There is a prospect of practical expedients / relief from modification accounting in the COVID-19 environment – as of the date of this document, ED 300 *COVID-19-Related Rent Concessions* - which proposes some relief - is in draft.

8a Lessee Modifications

Modification vs reassessment

Lease modification and remeasurement are two different concepts with potentially different accounting outcomes. Generally, a remeasurement takes place when there are changes in lease payments based on contractual clauses included in the original contract – such as changes in CPI, market price adjustment, or residual price guarantee (AASB 16.42). In such an instance, future cash flows are reforecast and present-valued utilising the discount rate set in the initial measurement of the lease (AASB 16.43).

A lease modification arises when the lease contract is altered such that future cash flows alter or the scope of the lease is changed. Where an increase in scope occurs, and the payment for this increase in scope is commensurate, a separate lease is accounted for (AASB 16.44). Otherwise, the original lease is remeasured by:

- Identifying a revised discount rate appropriate to the revised lease term, underlying asset and the lessee;
- Determining the net present value of future cash outflows using that revised discount rate;
- Adjusting the remaining Right of Use Asset for the increase or decrease in the lease liability. Where the Right of Use Asset is adjusted to a value below zero, a gain is recognised in profit or loss.

Example: Lease Abatement

RetailCo closed its stores on 15 March 2020. Economic and regulatory circumstances changed on 30 June 2020 such that RetailCo wished to reopen its stores, however the significant period of time with no cash inflow resulted in insufficient working capital to meet its lease obligations.

On 1 April 2020, RetailCo received a 6-month lease abatement from its landlord, starting 1 April and expiring 30 September 2020. RetailCo's IBR was 4% at lease inception; it is now 6%. Payments were $1,000 per month, expiring in 30 June 2021. Renegotiated payments remain consistent. Payments are in arrears.

Example: Lease Abatement

At 1 April 2020, the balance of the Right of Use asset was $15,000. The Liability balance was $14,607.

	Month		Original PMT		New PMT
1.1	April 2020	1.2	1,000	1.3	-
1.4	May	1.5	1,000	1.6	-
1.7	June	1.8	1,000	1.9	-
1.10	July	1.11	1,000	1.12	-
1.13	August	1.14	1,000	1.15	-
1.16	September	1.17	1,000	1.18	-
1.19	October	1.20	1,000	1.21	1,000
1.22	November	1.23	1,000	1.24	1,000
1.25	December	1.26	1,000	1.27	1,000
1.28	January 2021	1.29	1,000	1.30	1,000
1.31	February 2021	1.32	1,000	1.33	1,000
1.34	March 2021	1.35	1,000	1.36	1,000
1.37	April 2021	1.38	1,000	1.39	1,000
1.40	May	1.41	1,000	1.42	1,000
1.43	June	1.44	1,000	1.45	1,000
PV Cash Flows			$14,607		$8,779
Change +/(-)			($5,828)		

Journal:		
Dr. Lease Liability	5,828	
Cr. RoU Asset		(5,828)
To adjust lease accounting for lease abatement		

Decrease in lease liability > Right of Use Asset

If the Right of Use Asset had been $5,000 at the date of modification, the decrease ($5,828) is more than the Right of Use Asset. In such a case, a gain is recognised:

Journal:		
Dr. Lease Liability	5,828	
Cr. RoU Asset		(5,828)
Cr. Gain (Profit or Loss)		(828)
To adjust lease accounting for lease abatement		

8b Lessor Modifications

Finance Leases

Lessor accounting for modification of finance leases is detailed in AASB 16.79 to .80. Similar to lessee accounting, where an increase in scope exists and the increase in consideration is commensurate, a separate lease exists. Where this is not the case, the lessor must:

- Reassess the accounting for the lease and determine if the lease *would have been considered an operating lease if the modification had been known*; and, if so:
  - Create a new lease from the effective date of the modification; and
  - Reclassify the lease receivable balance at the date of modification to plant and equipment.
- Where the lease remains a finance lease, the Lease Receivable is remeasured by the application of AASB 9. In such a case, assuming that that the receivable is classified as amortised cost, the change in future cash flows is a remeasurement event resulting in a gain or loss within profit or loss. Refer to Section 10b, subsection "Loans at amortised cost".

Operating Leases

The guidance on modification of operating leases from a lessor's perspective is limited within AASB 16. It requires only that any modification be considered a new lease, such that any remaining prepayments and accruals are included in the accounting for this new lease. It is unclear if the straight- line balance resulting from lessor accounting is considered an accrual, however in the opinion of GT, consistent with the approach when applying AASB 117, the straight-linebalance should be considered a part of the lease prepayments and accruals.

In such an instance, the future cash flows are recognisedon a straight line (or other systematic) basis, adjusted for any prepayments or accruals such that the balance of any straight-line items is $0 at lease-end.

Impairment

Due to the change in fair value of future cash flows, impairment indicators may exist such that impairment of the individual assets should be considered.

9. Financial instrument modification – debt instruments

AASB 9 addresses modifications to loan repayments both from a borrower and lender perspective. Such modifications occur when (as limited examples):

- Future patterns of repayment are altered;
- Interest rates alter; or
- Balances, or a part of the balance, is forgiven.

The accounting for each differs depending on whether the entity is the lender or the borrower.

Modification of financial instruments is an extremely complex area and may result in outcomes such as change in measurement basis from amortised cost to fair value through profit or loss, or vice versa, and potentially a gain or loss on modification. For financial liabilities, in certain circumstances (such as where changes in credit risk have occurred) gains and losses are required to be recognised in part within other comprehensive income (rather than profit or loss).

The discussion below, by necessity, general in nature and relatively simplistic. We recommend that any further questions for complex contract modifications be discussed with Financial Reporting Advisory or your Grant Thornton relationship partner.

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9a Borrower modifications

Where the entity is the borrower where a modification has occurred, the entity must consider whether a debt modification or extinguishment has occurred. Given the length and detail of this topic, a separate document has been prepared – we suggest users of this refer to the guide on **Loan Restructuring**. We note that, as identified above, this document is not a complete guide to financial liabilities and their modification.

9b Lender modifications

Loans at fair value through profit or loss

Loans at fair value are measured based on the present value of future cash flows where variations may occur in all inputs within the fair value model – including risk-based changes to the discount rate within the fair value model. As a result, there is minimal impact of a modification of future cash flows which would not normally be the case.

The modified future cash flows are incorporated into the fair value model, with appropriate adjustments to the discount rate of these cash flows, and the change in fair value adjusted through profit or loss.

Loans at amortised cost

Accounting for modification of future cash flows for assets measured at amortised cost is relatively complex. The modification of contractual cash flows for such assets is addressed in paragraph 5.4.3 of AASB 9 *Financial Instruments.*

Unlike a borrower modification (i.e. modification of a financial liability) financial assets are only derecognised when (AASB 9.3.2.3):

a. The rights to future cash flows expire; or
b. The financial asset is transferred and qualifies for derecognition (AASB 9.3.2.4 to .3.2.6).

This document will assume that the rights to future cash flows have not expired or transferred.

As noted above, when financial assets that are debt instruments are modified, it may be appropriate to reassess their classification as measured at amortised cost or at fair value through profit or loss – this is required by AASB 9.B4.A.9B.

Where no changes to the basis of measurement or derecognition event occurs, financial assets measured using amortised cost are remeasured based on the value of cash flows, without adjusting the effective interest rate of the instrument. Practically, this means that in an example (with no change in term) where the total cash payments increase, the value of the financial asset is increased and a gain recognised; where the total cash payments decrease, the value of the financial asset is decreased and a loss recognised.

This gain or loss is recognised as a modification gain or loss within profit or loss.

Example: Modification of cash flows for a financial asset measured at amortised cost

LenderCo lent $1,000 to BorrowerCo at an effective interest rate of 9.0%, paid annually in arrears in a past period. At the end of Year 0, BorrowerCo and LenderCo negotiated a change in contractual cash flows such that interest will be paid according to Case A & Case B, below. At the end of Year 0, the debt is due in 5 years, with principal payable in due at that date.

For Case A, interest is paid in arrears at a rate of 5% of the principal balance.

For Case B, interest is paid in arrears at a rate of 15% of the principal balance.

LenderCo receives the following cash flows:

	Original Debt	Case A	Case B
Int. Rate	**9%**	**5%**	**15%**
	Cash Flows		
Year 1	90	50	150
Year 2	90	50	150
Year 3	90	50	150
Year 4	90	50	150
Year 5	1,090	1,050	1,050

These cash flows are measured relative to the original effective interest rate of 9% to derive the adjusted amortised cost subsequent to modification, which is then compared to the carrying value. A gain or loss results, recognised as a modification gain or loss in profit or loss:

	Original Debt	Case A	Case B
NPV	**1,000**	**844.41**	**1,233.38**
Gain (Loss)	**-**	**(155,59)**	**233.38**

10. Financial instruments – counterparty risk

Financial instruments require, by their nature, that a third party be involved for them to exist, whether it be:

- A customer;
- A supplier;
- An investee;
- An investor;
- A financial institution; or
- A derivative counterparty.

Where a financial asset is held, its fair value is impacted by the creditworthiness of the counterparty: for items measured at amortised cost, this is reflected in expected credit losses (refer Section 5); for investments measured at fair value (whether through other comprehensive income or through profit or loss) this is counterparty risk impacts the fair value of the instrument directly.

Below, we have considered certain specific types of financial asset impacted by the COVID-19 pandemic.

Cash at bank

Substantially all entities hold cash at a financial institution – a financial asset which is considered by default to be measured at amortised cost.

Although rarely considered as such, by reporting cash at bank at its face value entities are implicitly stating that there are no (or not more than insignificant) expected credit losses associated with the financial asset – and so the face value is equal to the reported value.

This is true in normal times for Australian and most foreign banks (or, more broadly, Authorised Depository Institutions – ADIs) – but the situation may have altered as a result of COVID-19.

Cash at bank should be considered for indications of expected credit losses in-line with Section 5, particularly considering:

- The availability of government-funded insurance (limited to $250,000 per depositor per ADI in Australia);
- Any amounts held in excess of government-funded insurance;
- The credit rating of the bank;
- The susceptibility of the bank to losses;
- The potential for sovereign risk (i.e. governments not honouring guarantees).

While it is likely that Australian ADIs will not default on their cash deposits, risk may be elevated, particularly for smaller banks. Cash held in foreign jurisdictions where no insurance exists, or with non-ADIs holding deposits, should be carefully considered and the ECL model applied.

Derivatives

Derivatives include a promise for performance by both the entity and a counterparty. Where the entity has acquired a promise for the counterparty to perform – for example, to sell the entity a foreign currency at a fixed price, or to swap a fixed for variable interest rate – the entity may reflect a derivative asset in its financial statements; AASB 9 requires that such a financial instrument be measured at fair value through profit or loss.

Many entities have assumed minimal performance risk in relation to these derivatives – that is, they have assumed that the counterparty can and will perform as contractually required. In the current environment, given significant downturns in creditworthiness of many counterparties, the entity should consider whether the counterparty to the financial instrument has the economic capacity to perform, and whether, given the counterparty's creditworthiness, the fair value of the instrument is impacted.

Examples of instruments that may be impacted include, but are not limited to:

- Interest rate swaps;
- In-the-money call options;
- In-the-money put options; and
- In-the-money foreign currency forwards or futures.

Example: counterparty risk

NutCo, a supplier of almonds to grocers, agrees to a acquire product from a supplier in Europe. NutCo contracts with HedgeCo, a high-risk, low cost counterparty to fix the exchange rate at the date of settlement to EUR 0.80. At reporting date, the AUD has decreased in value to EUR 0.60; the contract has a nominal fair value of AUD150,000.

10 days before reporting date, HedgeCo collapses and it is announced that all derivatives are unfunded and will not be settled. The fair value of the derivative is thus reasonably closer to AUD 0 than AUD 150,000.

11. Provisions

A provision is an uncertain liability dependant on either the timing or amount of future expenditure (AASB 137.11). Provisions are recognised when an entity has a present obligation; it is probable that an outflow of resources is required to settle the obligation; and a reliable estimate can be made.

Entities facing a severe downturn due to COVID-19 may consider or implement restructuring plans such as closure of part of its business or a downsizing of operations. A provision for the costs associated with such decisions may only be accounted for if a probable and reliably estimable present obligation resulting in an outflow of economic benefit exists (AASB 137.14).

Guarantees

Entities acting as guarantors on behalf of other entity/individuals need to consider how the current global situation has impacted those guaranteed entities. Considering all facts and circumstances, a provision relating to the guarantee may be required where the guaranteed entity is unable to meet the guaranteed obligation as and when it falls due. The provision is measured based on the expected outflow to meet the obligation.

Onerous contracts

An onerous contract is a one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it (AASB 137.10). The accounting for onerous contracts includes creating a provision based on the unavoidable costs of meeting the entity's obligation under the contract (AASB 137.66).

Entities must consider whether any of their contracts have become onerous due to the downturn in the global economy as a result of COVID 19 and review contracts to determine if there are any special terms that may relieve either party of the contract of its obligations (Force Majeure).

Restructuring provisions & termination benefits

Restructuring provisions and provisions for termination benefits are typically recognised hand-in-hand. Restructuring provisions are recognised when there is a material change to an entity's business that will result in material costs being incurred by the entity. A provision is recognised for these costs when the entity has established a detailed business plan identifying at least:

- the business or part of a business concerned;
- the principal locations affected;
- the location, function, and approximate number of employees who will be compensated for terminating their services;
- the expenditures that will be undertaken; and
- when the plan will be implemented;

and the entity has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Where a restructure does not occur, or is not planned, but termination of employees is expected, termination benefits may meet the definition of a provision in absence of a restructuring provision. A termination benefit results from either an entity's decision to terminate an employee's employment or an employee's decision to accept an entity's offer of benefits in exchange for termination of employment (AASB 119.159)

As a result of difficult economic conditions, some entities have - or will - downsize their workforce. If the entity offers or is required to pay termination benefits to the affected employees, management must consider if these expenses are paid in exchange for termination or in exchange for service (AASB 119.161). Where the payment is for termination and that termination has not occurred at reporting date, a provision is be required.

A liability is recognised when an entity can no longer withdraw the offer.

12. Other considerations

12a Joint ventures and associates

Joint ventures and associates accounted for using the equity-method are subject to impairment testing by application of AASB 128 *Investments in Associates and Joint Ventures*. Paragraphs .40 to .43 of this standard require impairment testing to occur if "there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the net investment (a 'loss event') and that loss event has an impact on the estimate future cash flows from the net investment that can be reliably estimated." (AASB 128.41A).

Examples given in that paragraph include significant financial difficulty, default, probable bankruptcy, and financial support being required by the entity.

It is reasonable that, for the majority of entities, the impact of COVID-19 will meet the definition above for equity-method accounted investments. Where such testing is completed, it is completed by application of AASB 136 (refer Section 3, above), subject to certain modifications including consideration of timing of cash flows from sale of the investment and from dividends. Management should clearly document their judgements as to why impairment testing was or was not appropriate given knowledge of all facts and circumstances relating to the equity-method accounted investment.

12b Valuation of inventories

AASB 102 requires that inventory be carried at the lower of cost and net realisable value ("NRV"). In a depressed economy, each entity should consider whether net realisable value is
below cost – that is, is it probable that inventory will be required to be priced below cost to convert to cash? As management, strategic decision making may drive this determination and decisions made subsequent to the reporting date may indicate conditions that were in place at that date. The closer the timing of the date of sale below cost is to reporting date, the more likely that the conditions were in place at that date; conversely, the longer that inventory is held with sale subsequent to reporting date, the more likely that sales below cost will be required.

The underlying condition in place which is being considered for existence is customer demand – if customer demand is sufficient that discounting is not required, neither circumstance (sales below cost nor unsold stock) is likely to occur. The longer the interval between reporting and balance date, the greater the risk that underlying demand is insufficient to support the carrying value of inventory.

Management should consider metrics such as:

- Forecast sales post year-end;
- Discounting by competitors;
- Success of alternative sales channels; and
- Centrally forecast economic data.

12c Deferred Taxes

Deferred tax assets, especially those arising from unused tax losses, should only be recognised where it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised. A variety of indicators have been identified which may give rise to non-recognition of such deferred tax assets; refer to TA Alert 2019-12 *Recognition of Deferred Tax Assets from Tax Losses – Additional Guidance* for detailed discussion.

12d Borrowing costs

AASB 123 requires that an entity capitalise borrowing costs incurred that are directly attributable to the construction or acquisition of a qualifying asset – typically being intangible assets (applying AASB 138 *Intangible Assets*) or property, plant and equipment (applying AASB 116 *Property Plant and Equipment*). Where entities are capitalising borrowing costs and suspend production of the qualifying asset (either temporarily or permanently), borrowing costs incurred subsequent to the suspension must be expensed.

12e Insured events

Entities may hold insurance that covers them for losses incurred for business disruption, or for third party claims (including for non-performance), giving rise to a provision (refer Section 11, above).

Business disruption

Reimbursement for business disruptions are not a 'reimbursement right' as defined by AASB 137. Typical practice therefore applies AASB 116 Property Plant and Equipment by analogy; the expected cash inflow is recognised as an asset when it has an unconditional right to receive the cash inflow (or insurance proceeds). This will require conditions to be met, such as the claim not being disputed by the insurer and that the claim itself was insured.

The compensation receivable is measured by reference to the expected cash inflows, discounted at a rate that reflects the credit risk of the insurer. Such as a receivable may reasonably be expected to be measured at amortised cost as defined by AASB 9; an appropriate expected credit loss reserve should thus be incorporated (Section 5).

Reimbursement for third party claims – for instance, non-performance

Such insurance gives rise to a potential asset, being the amount expected to be recovered by the insurance claim for the provided-for item, where a provision is also recognised (Section 11). The asset is only recognised on-balance sheet where recovery is 'virtually certain'. Gains and losses incurred on provisions and associated insurance, when occurring in the same period, may be recognised net within profit or loss.

12f Hyperinflation

Although rare, hyperinflation may reasonably be an expected outcome for certain **countries**. Although no specific guidance exists in IFRS on what denotes a hyperinflationary currency, it is generally held that a currency that depreciates in value (by reference to the currency's CPI or other index) by 100% in a three year period is considered hyperinflationary. As of January 2020, such countries included:

- Argentina;
- South Sudan;
- Sudan;
- Venezuela; and
- Zimbabwe

and were projected to include the Islamic Republic of Iran.

Accounting for hyperinflationary currencies

AASB *129 Financial Reporting in Hyperinflationary Economies* requires that entities apply a restatement approach where operations occur in hyperinflationary economies; this requires that the balance sheet and profit or loss be restated on a price-index adjusted basis, by reference to the price index at the date of the transaction and that at reporting date. The elements of the statement of changes in equity are also adjusted.

Comparatives are restated where the hyperinflationary currency is the presentation currency, otherwise they remain unadjusted. Any net increase or decrease is recognised in profit or loss after all elements are adjusted as a "gain or loss on net monetary position".

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