Jersey Funds Association

Accounting update

23 September 2020

Building a better working world

Agenda

- Recap of last year
- Going concern considerations
- Fair value considerations
- Debt modifications and exchanges
- IFRS 16: Rent concessions

Recap of last year

Recap of last year

- Adoption of new accounting standards
  - IFRS 9 “Financial Instruments”
  - IFRS 15 “Revenue”
- Other accounting standards
  - Classification of loans – current vs non-current
  - Finance costs on qualifying assets
- 2019 New standards to be adopted (IFRS 16 “Leases”)
- IFRIC agenda item (IFRS 10)
- UK GAAP update (FRS 102)
- Alternative Performance Measures (APMs)
- IPEV Guidelines update
- UK Corporate Governance Code amendments
- Impact of Brexit on the application of IFRS in the UK
- New IFRS standards

Going concern considerations

Going concern considerations

World wide pandemic

- On 11 March 2020, the WHO announced that the coronavirus outbreak can be characterised as a pandemic

Economic impact on entities

- Significant negative financial impact on a large number of entities
- A number of entities have seen income drop significantly
- Leading to:
  - Lower cash balances
  - Difficulty meeting liabilities as they fall due
  - Potential loan covenant issues

Going concern considerations (continued)

Accounting requirements

- IAS 1 *Presentation of Financial Statements* states:
  - When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. [IAS 1.25]
  - In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. [IAS 1.26]
- The level of detail necessary depend on facts and circumstances
  - A history of profitable operations and access to sufficient funds reduces the level of detail
  - For entities negatively impacted financial, more careful consideration is necessary
- Under IAS 10 *Events after the Reporting Period*, a change in going concern assessment post balance date is an adjusting event

Going concern considerations (continued)

Accounting requirements

- Where management determine that a “material uncertainty” exists casting significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties
- Examples of such material uncertainties include:
  - Entity dependant on bank funding, due for refinancing within period of going concern assessment, and uncertainty about entities ability to refinance
  - Insufficient headroom on covenants leading to debt becoming immediately repayable, and uncertainty on entities ability to remedy the breach
- Even where management determines no “material uncertainty” exists, but the conclusion is based on significant judgements, such judgements are required to be disclosed [IAS 1.122]
- Similar accounting requirements exist under FRS 102 “The Financial Reporting Standard applicable in the UK and Republic of Ireland”
  - the period of the assessment is for 12 months from the date of approval of the financial statements

Going concern considerations (continued)

Auditing standards

- ISA 570 “Going Concern” requires management’s assessment of the entity’s ability to continue as a going concern for a period of more than twelve months from the date of approving the financial statements [ISA 570.11]
- Where the assessment is for a period less than 12 months and management have not disclosed this fact, the auditor is required to report on this in the auditor report [ISA 570.18–1]
- As a result of the negative impact on entities, there has been an increased auditor focus on management’s going concern assessment
- This has resulted in a number of entities having to provide more detailed going concern assessments

Going concern considerations (continued)

Practical issues

- Cash flow models:
  - are based on a number of judgements and assumptions
  - given the financial impact on entities, cash flow models become more sensitive to changes in inputs
- The assessment should consider the sensitivity of the significant assumptions
  - This can be done by preparing multiple cash flow forecasts considered to be reasonably possible (e.g. best case scenario, base case scenario, worst case scenario etc.)
  - Another method is “reverse stress” testing where an input is reduced to the point that the cash flow forecast indicates a problem
    - E.g. Bank funding covenant that cash balance will be at least £10m, how much does income have to reduce to cash to reduce to £10m

Going concern considerations (continued)

Management considerations

- Under accounting and auditing standards the going concern assessment has to be for a period of 12 months subsequent to date of approval
- Cash flow forecasts:
  - Where funds have previously prepared cash flow forecasts, it has been necessary to update closer to date of signing due to significant uncertainty on impact on entities
  - For other funds has required cash flow forecast to be prepared for the first time
    - This has proved challenging for certain types of funds, particularly Private Equity and Real Estate Funds
- Closer attention should be given to debt covenants, as headroom decreases
- Sensitivity analysis on significant assumptions should be assessed:
  - “Reverse stress” testing is not the same as “reasonably possible” scenarios

Fair value considerations

Fair value considerations

Impact on fair values

- The impact on fair value measurement arising from the coronavirus pandemic and the ensuing economic and market disruptions varies across countries, markets and industries
- There has been a significant increase in volatilities and associated uncertainties, and it appears this is likely to continue
- When valuations are subject to significant measurement uncertainty it can lead to a wider range of possible estimates
  - Entities are required to apply judgement to determine the point within that range that is most representative of fair value in the circumstances
- For certain types of assets, valuation issues have arisen due to a lack of recently available information incorporating the effects of the Covid-19 crisis
  - E.g. for investment property valuations, this led to a number of external property valuers including ”material valuation uncertainty” clauses

Fair value considerations (continued)

Accounting impact – disclosures

- The increased volatility and uncertainties on fair values, should be reflected in both the fair value disclosures required by IFRS 13 and the financial risk management disclosures required by IFRS 7
- For level 1 fair values (e.g. investments in listed shares), consideration should be given to whether the sensitives disclosures are still considered to be “reasonably possible” [IFRS 7.40 a)]:
  - E.g. an entity may have had an equity price sensitivity of +/- 10% in the prior year, is this still reasonable this year, given the stock exchange declines in the first quarter were approx. 25%?
- For level 3 inputs (e.g. investment properties) a similar consideration is required whether prior year reasonably possible alternative assumption for inputs continue to be appropriate in the current year [IFRS 13.93]:
  - E.g. what was the actual change in the input both at year end and subsequent
- Generally we would expect to see an increase in sensitivity levels reflecting increased volatility and uncertainties

Fair value considerations (continued)

Accounting impact – disclosures

- Where there is a change in either fair value technique or sensitivity calculations any change in methods is required to be disclosed
  - E.g. for property valuations changing from a market based approach (e.g. square foot for similar properties in similar locations) to an income based approach (e.g. discounted cash flows)

Debt modifications and exchanges

Debt modifications and exchanges

- Due to current economic circumstances we are seeing an increase in entities encountering difficulties servicing existing loan arrangements
- This could lead to an exchange or a modification of the current loan arrangements with an existing lender
  - Examples of modification include changes in the maturity date or interest payments
  - An example of an exchange is terminating an existing loan prior to maturity date and entering into a new loan
- For financial liabilities such modifications can be accounted for as:
  - an extinguishment where the old loan is derecognised and the new loan is recognised; or
  - a modification where the old loan is not derecognised, but its carrying value may be adjusted

Debt modifications and exchanges (continued)

- Under IFRS 9, an exchange with "substantially different" terms or a substantial modification of the terms should be accounted for as an extinguishment
- An exchange is considered to be "substantially different" where:
  - the net present value of the cash flows under the new terms (including any fees paid net of any fees received) discounted at the original effective interest rate is at least 10% different from the discounted present value of the remaining cash flows of the original debt instrument; or
- A fundamental change in terms is considered to be a substantial modification
  - Some example are the inclusion of an embedded equity feature or a change in the currency of the loan

- Note: for the purpose of the "10% Test" only fees paid to the lender are included in the calculation

Debt modifications and exchanges (continued)

Accounting for extinguishments

- The existing loan is derecognised
- All costs paid to the lender or other costs incurred (e.g. legal fees) are expensed (included in the calculation of gain or loss on extinguishment)
- The new loan is recognised at fair value
  - In practice there may be some difficulty in determining the fair value of the modified loan, as the interest rate may not be a market rate (e.g. due to taking into account the fees on the renegotiation), i.e. the nominal value of the new loan cannot be assumed to represent FV

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Debt modifications and exchanges (continued)

Accounting for modifications

- The existing loan continues to be recognised
- The accounting is as follows:
  - The carrying value of the loan is adjusted to the present value of estimated future contractual cash flows on the new loan discounted at the original EIR;
  - The difference compared to the carrying value of the old loan is recognised immediately in profit or loss; and
  - All costs incurred are amortised over the remaining term of the loan on an EIR basis or another approach that approximates this such as a straight-line basis

Debt modifications and exchanges (continued)

Practical application of accounting for costs

- Entity negotiates a change in loan terms with existing lender
- The lender charges a GBP 300k fee, and the entity pays a lawyer GBP 100k legal costs
- "Substantially different" (i.e. 10%) test
  - To calculate the present value of future cash flows on the revised loan terms, include the GBP 300k, but the GBP 100k is ignored
- Accounting entries:
  - If treated as an extinguishment – Dr **Gain or loss on derecognition** [A] GBP 400k, Cr Cash GBP 400k
  - If treated as a modification – Dr **Loan payable** [B] GBP 400k, Cr Cash GBP 400k

[A] This amount would be included as part of the difference between the carrying value of the existing loan and the fair value of the new loan

[B] This amount is deducted form the existing loan and is amortised to the revised maturity date

IFRS 16: Rent concessions

IFRS 16 amendment: Rent concessions for lessees

Overview

- Different forms of rent concessions granted to lessees
- Usually, accounting for a change in lease payments depends on whether the change meets the definition of a lease modification
- IASB has issued an amendment to IFRS 16 that provides a relief for lessees on how to account for such rent concessions
- Only lessees can apply the rent concession relief
- The amendment published by the IASB can be applied immediately
- EU endorsement?

IFRS 16 amendment: Rent concessions for lessees (continued)

What is the practical expedient and when can it be applied?

- Can only be applied to rent concessions occurring as a direct consequence of the coronavirus pandemic
- Following conditions must be met:
  - Change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change
  - Any reduction in lease payments affects only payments originally due on or before 30 June 2021
  - There is no substantive change to other terms and conditions of the lease.
- Applied consistently to all lease contracts with similar characteristics and in similar circumstances

IFRS 16 amendment: Rent concessions for lessees (continued)

How does the amendment apply in practice?

- Allows lessees to account for any change in lease payments resulting from Covid-19 rent concessions in the same way as it would account for the change applying IFRS 16 if the change were not a lease modification
- Several potential approaches to do this are:
  - Accounting for the concession in the form of forgiveness or deferral of lease payments as negative variable lease payments
  - Accounting for the concession in the form of forgiveness or deferral of lease payments as the resolution of a contingency that fixes previously variable lease payments; or
  - Accounting for the concession in the form of a deferral of payments as if the lease is unchanged.

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IFRS 16 amendment: Rent concessions for lessees (continued)

Disclosures for lessees

- A lessee that applies the practical expedient discloses that it has done so to all rent concessions that meet the conditions for the practical expedient
  - If not applied to all such rent concessions, disclose information about the nature of the contracts to which the practical expedient has been applied
- Disclose the amount recognised in profit or loss to reflect changes in lease payments that arise from rent concessions to which the practical expedient has been applied
- Disclos**ure of** the cash flow effects of rent concessions **is** relevant regardless of whether or not the practical expedient has been applied.
- Consider post balance sheet event disclosure

IFRS 16: Rent concessions for lessors

Lessor accounting for rent concessions

- IFRS 16 amendment does not apply to lessors
  - Lessor must firstly assess whether the concession meets the definition of a lease modification
- Modification to an operating lease is accounted for as a new lease from the effective date of the modification
  - Recognise lease payments as income on a straight line basis or another systematic basis
  - Impact of rental concessions therefore likely to be spread over remaining lease term
- Modification to a finance lease – accounting depends on whether the modification is accounted for as a separate lease or not
  - Separate lease if modification increases scope/consideration
  - If not, then if the lease would have been an operating lease at inception date, then treat as a new lease from date of modification otherwise IFRS 9 is applied to the net investment in lease

IFRS 16: Rent concessions for lessors (continued)

Fact pattern for the following lessor accounting examples

- Lessee makes fixed lease payments of £100 to the Lessor at the beginning of each month.
- Lease term ends on 28 February 2022.

IFRS 16: Rent concessions for lessors (continued)

Lessor accounting with modification to an operating lease where future lease payments of an operating lease are forgiven

- All lease payments due up to 30 June 2020 have been received in a timely manner.
- On 30 June 2020, in compensation for the closure of office, the Lessor agrees to forgive Lessees future lease payments for the months of July, August and September 2020.
- Recognise the operating lease income from the modification as a new lease from the effective date of the modification
  - Dr Lease receivable (100x17/20 months) £85
  - Cr Operating lease income £85

IFRS 16: Rent concessions for lessors (continued)

Lessor accounting where the operating lease receivable is waived

- 2 approaches
- IFRS 16 - the rent concession results in a change in the consideration for the lease that was not part of the original terms of the lease and therefore may be viewed as a lease modification
- IFRS 9 - the forgiveness of the past lease payments is an extinguishment of the operating lease receivable and the derecognition requirements of IFRS 9 apply

IFRS 16: Rent concessions for lessors (continued)

Lessor accounting where the operating lease receivable is waived (continued)

- Due to its financial difficulties, the Lessee did not pay the lease payment for June 2020. Consequently, the Lessor recognised an IFRS 9 impairment loss of £20 on 30 June 2020
- On 1 July 2020, the Lessor grants a rent concession that waives £60 of the outstanding amount for June 2020. The remaining amount (£40) is paid shortly after.
- On 30 June 2020: Recognise the operating lease income and impairment loss
  - Dr Lease receivable £100
  - Cr Operating lease income £100
  - Dr Impairment loss on lease receivable £20
  - Cr Impairment allowance on lease receivable £20

IFRS 16: Rent concessions for lessors (continued)

Approach 1 – Lease modification under IFRS 16

- Recognise the lease incentive (forgiveness of CU 60) to enter into the modified lease and reverse the IFRS 9 allowance recognised in June 2020
  - Dr Lease incentive £60
  - Cr Lease receivable £60
- Recognise the partial cash receipt from the Lessee
  - Dr Cash £40
  - Cr Lease receivable £40
- Recognise the operating lease income (based on the monthly £100 payments) less amortisation of the lease incentive
  - Dr Lease receivable £100
  - Cr Operating lease income £100
  - Dr Operating lease income £3
  - Cr Lease incentive £3

IFRS 16: Rent concessions for lessors (continued)

Approach 2 – Derecognition of past lease receivable under IFRS 9

- Derecognise the past lease receivable that is forgiven
  - Dr Impairment allowance on lease receivable £20
  - Dr Derecognition loss on lease receivable £40
  - Cr Lease receivable £60
- Recognise the operating lease income (based on the monthly £100 payments)
  - Dr Lease receivable £100
  - Cr Operating lease income £100

IFRS 16: Rent concessions for lessors (continued)

Lessor accounting where operating lease income not expected to be fully recoverable, but lease not modified

- Lessee indicates that it will only pay 25% of the lease receivable due for the month of July 2020.
- Up to 31 July 2020, £25 has been collected and the Lessor does not expect the remaining amount of £75 due in respect of July to be recovered considering the Lessee's financial condition.
- 2 approaches

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IFRS 16: Rent concessions for lessors (continued)

Approach 1 – Recognising the full operating lease income

- Recognise the full operating lease income on a straight-line basis of £100 per month
  - Dr Lease receivable £100
  - Cr Operating lease income £100
- Recognise the cash receipt from the Lessee
  - Dr Cash £25
  - Cr Lease receivable £25
- Recognise an impairment loss against the lease receivable
  - Dr Impairment loss on lease receivable £75
  - Cr Impairment allowance on lease receivable £75

IFRS 16: Rent concessions for lessors (continued)

Approach 2 – Recognition of operating lease income to the extent collectable

- Recognise the operating lease income to the extent recoverable
  - Dr Lease receivable £25
  - Cr Operating lease income £25
- Recognise the cash receipt from the Lessee
  - Dr Cash £25
  - Cr Lease receivable £25

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IFRS 16: Rent concessions for lessors (continued)

Disclosures for lessors

- No specific disclosure requirements related to lease modifications
- But lessors will need to disclose information that is sufficient to enable users of financial statements to understand the impact of Covid-19 related changes in lease payments on the entity's financial position and financial performance

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