

COVID-19: Financial Reporting – Disclosures for significant judgements and areas of estimation uncertainty

29 September 2020



Background

The novel coronavirus (COVID-19) pandemic has spread around the globe. The virus has taken its toll on not just human life, but businesses and financial markets too, the extent of which is currently indeterminate. Entities need to carefully consider the accounting implications of this situation.

Some of the worst hit sectors include:



Aviation and Aircraft leasing is facing massive disruption with travel restrictions imposed by most jurisdictions.



Hospitality sector has been impacted with low occupancy in business and holiday destinations having to close down entirely.



Automobiles, apparel, consumer durables, pharmaceuticals, leather goods, electronics and others where the supply chain is dependent on countries worst hit by COVID-19.



Financial services have also been affected with significant investment losses with the Dow Jones index down 5% YTD with some of its leading financial services companies down up to 30% YTD. The FTSE 100 down 23% YTD with some of its leading financial services companies down up to 50% YTD.

This presentation identifies some key financial reporting areas that entities need to consider when determining the impact on their business, and on the results, financial position and disclosures in their financial statements. This is not an exhaustive list and there may be other areas not included in this presentation that entities should consider. The areas are not listed in order of importance.

Introductions



Michael Shelley
Partner– Audit and Assurance
T +353(0)1 418 2055
E Michael.Shelley@ie.gt.com



Dan Holland
Partner – Audit and Assurance
T +353 (0)1 418 2091
E Dan.Holland@ie.gt.com



Paul O'Dea

Director – FS Audit
T +353 91 53 2268
E Paul.ODea@ie.gt.com



Aileen O'Connor

Associate Director – Audit and Assurance
T +353 61 60 7937
E Aileen.OConnor@ie.gt.com



Mark Gatila

Manager – Audit and Assurance
T +353 (0)1 418 2045
E Mark.Gatila@ie.gt.com



Sam Gribben
Assistant Manager – Audit and Assurance
T +353 (0)1 418 2032
E Sam.Gribben@ie.gt.com

Scope

This presentation is focused on the following from a Covid 19 perspective:

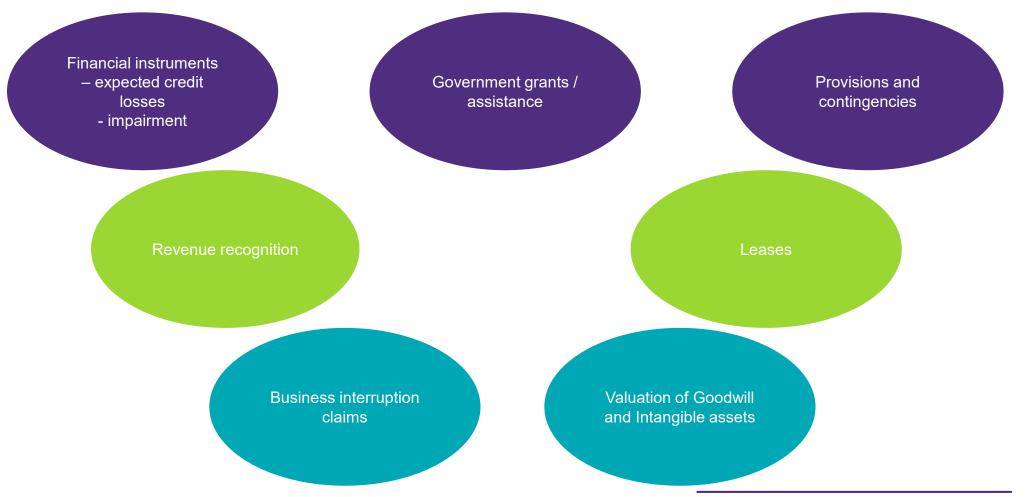


The issues discussed overleaf are by no means exhaustive and their applicability depends on the facts and circumstances of each entity. The topics overleaf cover just some of the challenges that companies have had to deal with in particular of the last 9 months. These are likely to play a significant part also in 2020 year end financial statement production processes.

Should anyone have any queries, there will be an opportunity to ask questions at the end of this webinar.

Introduction to disclosures

Examples of key judgements and areas where estimation uncertainty exist and for which disclosures are required are listed below.



Financial instruments - Example

Financial instruments – Example - Debt

Company A with a loan outstanding of €5m has requested a payment break in June 2020 due to reduction in income from their accommodation and food / catering business which relies on demand from consumers. Such demand has decreased by 80% up to June and was still 50% down on past trends up to Sept 2020 as the pandemic prolongs longer than expected. The loan has a term remaining of 15 years.

The Company has informed its bank that any cashflow earned during the summer months has been used for maintenance and expects the payment breaks will be needed up to year end.

The Company has informed its bank that it expects it will need the loan term to be extended in order to start making repayments again during 2021 in line with payment amounts pre the crisis.

Financial instruments – Example (cont'd.)

Questions:

Are loans with payment breaks defined as non-performing loans during period of Covid relief?

Are loans with payment breaks defined as non-performing loans after the period of Covid relief?

Expected Credit Losses (ECLs)when do these materialise and when should they be reported on? Will there have to be adjustments made to Cash Flow Statements in relation to loan payment breaks or mortgage moratoriums?

Are current deferment terms and payment breaks regarded as substantial modifications of current loan contracts? Is there a materiality level?

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Financial instruments – Example (cont'd.)

Answers:

- Payment breaks during relief period
 - Temporary measure
 - Enhance liquidity
 - Assumed not impacting economic value of loan
 - Consideration on case by case basis (i.e. is there significant increase in credit risk since inception)
 - **Example:** understand why no cashflow available to service interest/part of principal

- Payments breaks post relief period
 - Conclusion of significant increase in credit risk more likely
 - Possible lifetime loss ECL assessment versus 12 month ECL assessment
 - 90 day past day criteria for moving loan to default (nonperforming loan)
 - **Example:** understand how company can transition to making full repayments under extended loan term.

Financial instruments – Example (cont'd.)

Answers:

- Expected credit losses
 - Materialise when the loan defaults (i.e. payments greater than 90 days past due)
 - Cashflow statements should reflect aggregation of deferred payments as no cash has moved
 - Profit or loss in the period should be adjusted for non cash impairment charges
 - Example: default most likely to occur on 31 March

- Loan modifications
 - No materiality thresholds in determining loan modification
 - Quantitative and Qualitative factors to be considered
 - Present value of cash flows on new loan should be compared to book value of existing loan
 - Changes in collateral and other loan conditions should be considered from qualitative perspective
 - Example: Extended term request in this example likely to result in loan modification

Financial instruments – ECL – Macro considerations

Thinking ahead to year-end, things to focus on from an IFRS9 perspective are:

- continuously refining the estimate as conditions evolve (for example, reflecting epidemiological developments and changes to government stimulus packages);
- assessing whether adding more alternative scenarios, when modelling estimates, might be a better way to address increased uncertainty;
- testing judgements, including by comparison to peers, market inputs (such as credit default swap spreads), and consistency with fair value disclosures;
- focusing on governance, process and controls, in order to bring the same level of rigour to new or changed methods as would normally be applied to core models (a particular challenge for Sarbanes-Oxley or similar requirements);
- thinking differently about validation, including whether overlays and other adjustments can be covered by similar processes;
- considering what new data might become available and what Covid period behaviours (if any) will become drivers of default risk;

Government grants / assistance

The accounting for government grants and other forms of government assistance is set out in IAS 20 and, for Irish and UK GAAP, Section 24 of FRS 102.

It is essential to distinguish first of all between **government assistance** and **government grants** and ensure that grants are recognised only when the recognition criteria in IAS 20 is met.

Government assistance is "action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria."

Government grants are "assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the operating activities of the entity."

Government Assistance

Some Examples of Government Assistance;

Employment Wage Subsidy Scheme

'Warehousing' of deferred tax debts

Example re Interest Free Loan from the Government

RetailCo was significantly adversely affected 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 wish to re-open 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 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 present value of the debt:

NPV of cash flows	€1,000 / 1.10 ²
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 on receipt of the grant or over the term of the loan.

Disclosure requirements

Both IFRS and FRS 102 require the following to be disclosed in the financial statements:

- accounting policy adopted for grants, including the method of presentation adopted in the financial statements;
- the nature and extent of government grants recognised in the financial statements;
- an indication of other forms of government assistance from which the entity has directly benefited (examples may include free technical or marketing advice and the provision of guarantees); and
- unfulfilled conditions and other contingencies attaching to grants that have been recognised in income.

Provisions & Contingencies

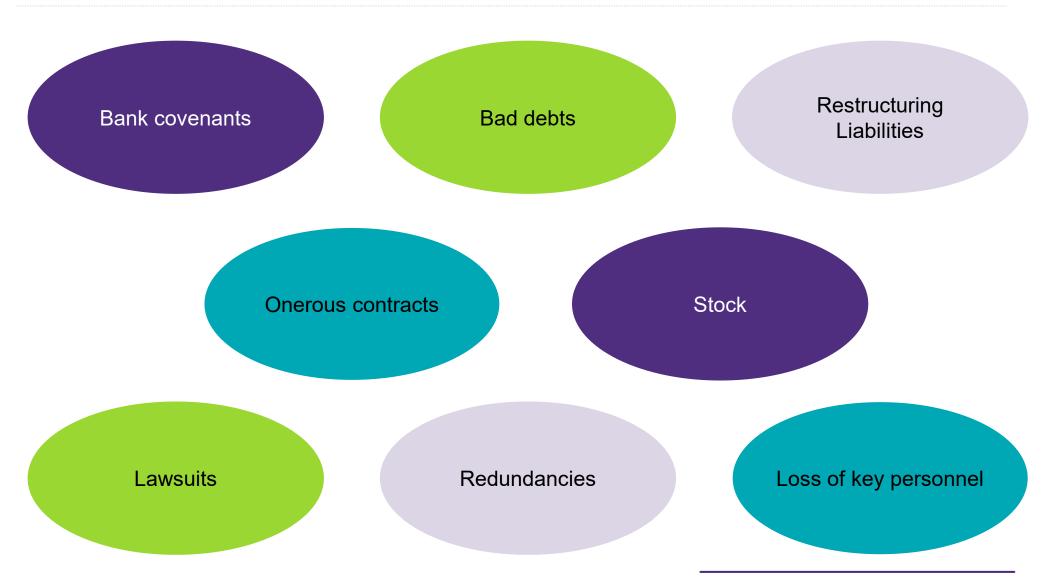
Provision: a liability of uncertain timing or amount.

Contingency: a possible asset or liability that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Contingent liability: a possible obligation depending on whether some uncertain future event occurs e.g. warranty, or a present obligation but payment is not probable or the amount cannot be measured reliably e.g. pending litigations, disputes etc.

Contingent asset: a possible asset that arises from past events, and an asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Examples



Examples (cont'd.)

Question:

On 12 December 2020 Unicorn Limited decided to close a division as due to the constraints of the Coronavirus it was no longer financially viable. Expected costs of closure were estimated as €2milion. No action was taken to communicate this to the affected parties until 23 January 2021.

Should a provision be provided?

Answer:

Provisions for restructuring may only be recognised when the entity has communicated to those affected their intention to restructure and formed a detailed plan for the restructuring. Neither of these seems to have happened at the reporting date, therefore no provision should be made. The subsequent communication is a non-adjusting event as the conditions were not met at the reporting date.

Disclosures – IAS 37

Under IAS37, for a provision to be recognised, it must meet 3 criteria:

- 1. Present obligation as a result of a past event (must be announced pre year-end)
- 2. Probable that an outflow of resources will be required to settle the obligation
- 3. Obligation can be reliably measured

For each class of provision, an entity shall disclose:

- a) the carrying amount at the beginning and end of the period;
- b) additional provisions made in the period, including increases to existing provisions;
- c) amounts used (i.e. incurred and charged against the provision) during the period
- d) unused amounts reversed during the period; and
- e) The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.
 - Comparative information is not required.
 - > For each class of provision, a brief description of:
 - Nature
 - Timing
 - Uncertainties
 - Assumptions
 - Reimbursement, if any

Revenue recognition

The five-step model framework under IFRS 15

IFRS 15 became effective on 1 January 2018 and applies to revenue from contracts with customers.

The core principle of IFRS 15 is that an entity will recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Applying this principle involves following the five-step model framework:

- 1) Identify the contract(s) with a customer
- 2) Identify the performance obligations in the contract
- 3) Determine the transaction price
- 4) Allocate the transaction price to the performance obligations in the contract
- 5) Recognise revenue when (or as) the entity satisfies a performance obligation.

The coronavirus outbreak could affect revenue recognition for most entities particularly in considering steps 1 and 3 above.

Revenue recognition (cont'd.)

1) Identifying the contract with a customer

IFRS 15 requires that an entity accounts for a contract when it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

Example

Seller Co. contracts with Customer Co. to deliver 1,000 units of equipment for a fixed price of €100,000. As a result of the coronavirus outbreak, Seller Co. assesses that it is probable that it will only be able to collect 70% of the amounts due under the contract. Based on its assessment of the facts and circumstances, Seller Co. expects to provide an implicit price concession and accept 70% of the fixed price.

Analysis

As a result of the above, Seller Co. recognises revenue of only €70,000. On subsequent measurement:

- if Seller Co. expects to collect more than €70,000, it recognises the excess as revenue.
- If it expects to collect less than, it recognises the shortfall as a bad debt expense

Disclosure requirements

Information about its contracts with customers:

- determining the probability of collecting the consideration;
- any impairment losses recognised any receivables or contract assets.

Revenue recognition (cont'd.)

3) Determining the transaction price

Example:

Seller Co, an entity with a 31 December year end, commenced a contract with Customer Co in May 2019 involving the production of eight tractors. Customer Co. agreed to pay Seller Co. €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, seven tractors had been delivered, with the eighth on schedule for delivery 31 May 2020. On 31 March 2020, Seller Co ceased construction due to social distancing rules with seven tractors delivered.

Analysis

- Revenue for 2019: delivery of 7 tractors plus share of bonus (€7,000 + €1,750) = €8,750
- Revenue for 2020: delivery of 7 tractors less revenue recognised to date (€7,000 €8,750) = (€1,750)

Disclosure requirements:

The significant judgments, and changes in the judgments that significantly affect the amount and timing of revenue recognised

- information about the methods, inputs and assumptions used for the following:
 - (1) determining the transaction price which includes estimating variable consideration
 - (2) assessing whether an estimate of variable consideration is constrained.

Revenue recognition (cont'd.)

Contract Modifications

An entity may modify its enforceable rights or obligations under a contract with a customer. Examples are as follows:

When a price concession is granted to a customer				
Concession is due to variability that existed at contract inception	Concession is provided solely as a result of COVID-19			
Treat as variable consideration even though triggered by COVID-19	Concession modifies the parties' rights and obligations			

Disclosure requirements:

- ✓ Judgments applied to assess whether a concession is treated as a variable consideration or a modification of contract.
- ✓ Judgments applied to assess when contract modifications are approved

Leases

IFRS 16 *Leases* has become an area of focus for entities and the International Accounting Standards Board (IASB). Lessors are providing lessees with rent concessions such as the following:.

Type of concession	Description	
Deferral of lease payments	Lessors allow lessees to defer making their lease payments until a later date, lowering the payments in one period and then increasing them in future periods.	
Forgiven lease payments	Lessors providing rent free periods or rent holidays with no other changes to the lease and no requirement to repay these amounts at a later date.	
Partial deferral and forgiveness of lease payments	Lessors allow lessees to defer some lease payments as well as giving them a rent-free period.	

In response to this, the IASB has therefore added a practical expedient to provide relief for lessees from lease modification accounting for rent concessions related to COVID-19.

Leases (cont'd.)

IFRS 16 contains specific requirements on accounting for lease modifications. Rent concessions that change the overall consideration for the lease are in the scope of these requirements.

Assessment of a rent concession

	Reassessment	Contract Modification
Scope	Changes in lease payments based on original contractual clauses: Changes in consumer price index (CPI) Market price adjustment Price Guarantee arrangement	Arises when the lease contract is altered such that future cash flows and/or the scope of the lease changes
Accounting	Income statement approach (adjust lease liability via P/L) ✓ Same discount rate at inception	Balance sheet approach (adjust lease liability and right-of-use asset) ✓ New discount rate
Additional disclosure considerations	 ✓ P/L impact of the reassessment ✓ Judgments and estimates regarding variable lease payments 	 ✓ Judgments and estimates in relation to: Revised discount rates applied Revised variable lease payments

Leases (cont'd.)

Practical expedients under the amended IFRS 16

The practical expedient applies only to rent concessions occurring as a direct consequence of the coronavirus outbreak and only if all of the following conditions are met:

- ✓ The 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

Disclosure considerations:

If applying the practical expedient, the amendments require the entity to disclose:

- that it has applied the practical expedient to all its rent concessions, or if only some of them, a
 description of the nature of the contract it has applied the practical expedient to, and
- the amount in profit or loss for the reporting period that reflects the change in lease payments arising from rent concessions (as a result of applying the practical expedient).

Leases - Example

Examples

Scenario 1

A lessee enters into a five-year lease agreement on 1 January 2019, the monthly payments are €1,000. The business of the lessee is significantly impacted by COVID-19 and so the lessor agrees to provide a rent concession. On 1 May 2020, the lessor agrees to forgive six months of payments unconditionally in 2020 with no adjustment to future rentals.

Analysis

 As the concession is unconditional, it is accounted for on 1 May 2020 as this is the date that triggers the event. The lessee accounts for this concession as a negative variable lease payment i.e. recognize the forgiven rent to P/L.

Scenario 2

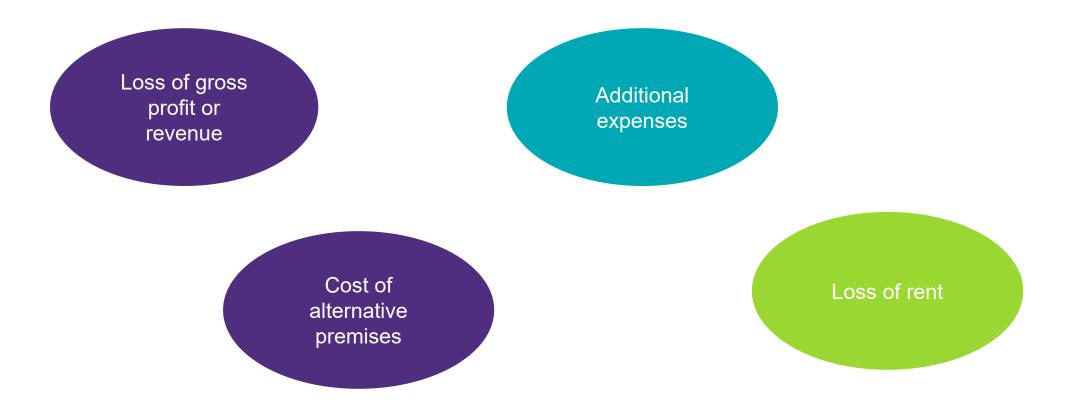
A lessee enters into a two-year lease agreement on 1 January 2020, the monthly payments are €1,000. The business of the lessee is significantly impacted by COVID-19 and so the lessor agrees to provide an unconditional rent concession. On 1 July 2020, the lessor agrees to defer three months of payments in 2020.

Analysis

- The lessee remeasures the present value of the lease liability using the original discount rate.
- The lessee then recognises the impact of the change in the present value of the lease liability in profit or loss when the rent concession becomes effective.

Business Interruption Claims- Circumstances

Examples of circumstances resulting from COVID 19 which may result in a business interruption claim:



Business Interruption Claims – Example

Example

A hardware distribution Company with a year-end 31 December 2020 experienced an outbreak of COVID-19 cases among a number of its warehouse staff at the beginning of October 2020, resulting in the Company having to shut down operations for a period of 2 weeks in the same month, resulting in an estimated €1.5m loss to gross revenue.

In November 2020, following the submission of a business interruption claim, the company received written confirmation from their insurer that a pay-out to the value of €1.5m would be paid to the Company in the days following.

Q1:. What is required to be disclosed in the financial statements at 31 December 2020?

Q2: What disclosures would be required if the Company had not received confirmation from its insurer that a pay-out was going to be made but was confident that it would?

See solutions on next page

Flowchart - Business Interruption Claims

Is it <u>virtually certain</u> that the insurer will pay-out on the BI claim?

Yes

Recognise the claim as an asset. No additional disclosures required



Is it *more probable than not* that the BI claim will be paid out?





Should not be reflected in the FS to 31 December 2020.

Disclose as a contingent asset in the notes to the accounts:

On 29 October 2020, the Company submitted a BI claim to its insurer for loss of revenue for the period from 7 - 21 October during which the Company was forced to close it's warehouse in response to an outbreak of COVID-19. Although the claim has not yet been accepted, the Company are confident that it will be on the basis that there is a pandemic clause in the Company's insurance policy. The value of the claim is for €1.5m.

Valuation of Goodwill

Examples of triggering events as a result of COVID-19:

Macroeconomic conditions (e.g., deterioration in general economy as a result of COVID)

Overall financial performance (e.g., negative or declining cash flows)

Cost factors (e.g., increases in raw materials, labor)

Industry and market considerations (e.g., deterioration in the environment in which the entity operates) Other relevant entityspecific events (e.g., changes in management or key personnel)

Goodwill & Intangible Assets- Example

Example

Company A is an aircraft leasing company and has a wholly owned subsidiary, SUB A, that manufactures aircraft. Restrictions on movement due to COVID-19 has caused demand for SUB A's aircraft to plummet for the year to 31 December 2020, resulting in a sharp decline in SUB A's EBITDA.

	2020	2019	2018
Revenue	€23,000,000	€35,000,000	€33,000,000
Revenue growth/(decline)	(34%)	6%	6%
EBIDTA	€3,800,000	11,130,000	10,500,000

Scenario 1: EBIDTA projections beyond 2020 show that results are forecast to remain in line with those of 2020 for a further 10 years. In addition, 2 key members of Sub A's management team resigned at the end of 2020.

Scenario 2: Despite a sharp decline in EBITDA in 2020, restrictions have been eased significantly in Q1 2021, resulting in expected EBIDTA returning to 2019 levels over the next 10 year period.

Valuation of Goodwill

Considerations for disclosure:

Scenario A: Impaired

Other possible impairment indicators

Scenario B: Not Impaired

- Sensitivity of projections to future restrictions
- Reasonableness of the 10 year EBIDTA projections
- Other possible impairment indicators

Information specific to a particular industry

Sensitivity of judgements and estimate to change

Evaluation of multiple scenarios of best estimate

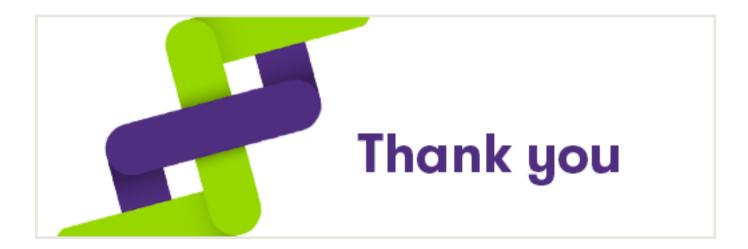
Questions



We hope you have found the information in this presentation useful. Now more than ever the need for clients and their auditor or advisor to work closely together is essential, so if you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit www.grantthornton.ie for further information.

In summary

Thank you for taking the time to attend our webinar this morning, we do hope you found it beneficial. Should you wish to contact any of our team directly, please do not hesitate to do so.



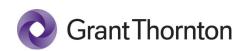
Disclaimer

- These slides are not considered to be specific financial reporting advice, they are general in nature and therefore no reliance should be placed on the information contained therein.
- These slides set out our understanding of key financial reporting areas based on information currently available. The information contained in these slides does not purport to be comprehensive but is purely for guidance and discussion purposes only.

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