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Presenter

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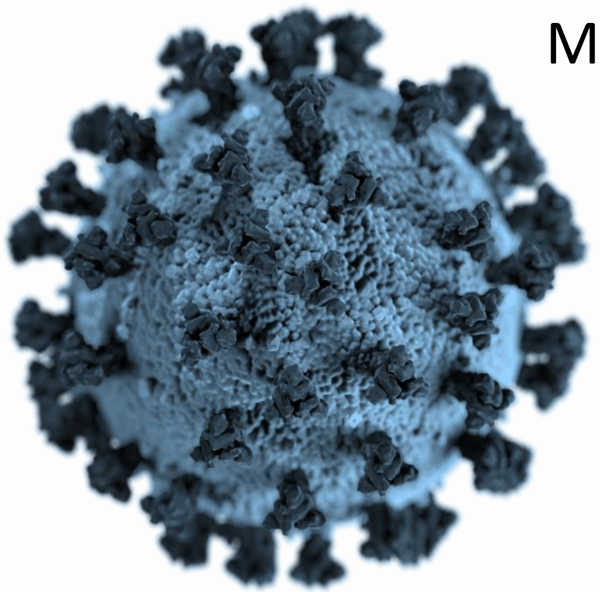
Milan van Wyk CA(SA)

Milan van Wyk is a qualified chartered accountant. He is currently employed as a senior lecturer in accounting at the University of Johannesburg. He holds a M.Com International Accounting Degree (Cum Laude). He is actively involved in training and education of aspiring accountants in the profession. He is also involved with the JSE Proactive Monitoring Project.

IFRS UPDATE 2020

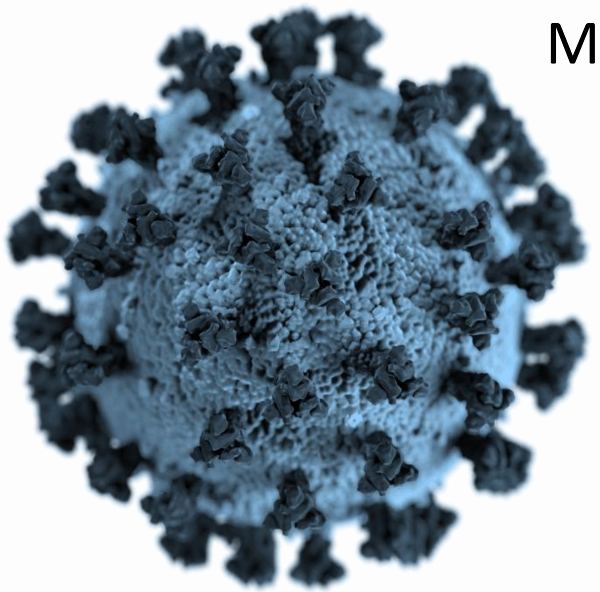
Applying COVID 19 to IFRS 9, IFRS 15 and IFRS 16

Milan van Wyk CA(SA)



IMPACT OF COVID-19 ON IFRS REPORTING

Milan van Wyk CA(SA)



BACKGROUND TO COVID-19

- Major impact on the global economy and South Africa in particular
- Business needed to limit/halt operations
  - Travel, hospitality, transport, retail….
- Disrupted the global markets
- Impact the reporting on IFRS

BALANCE SHEET PERSPECTIVE

LINE ITEM	2020 Impact?	IFRS Standard
Property, plant & equipment	Yes	IAS 16, IAS 36 (impairments and estimates)
Investment Property	Yes	IAS 40, IFRS 13 (fair value estimation)
Goodwill	Yes	IAS 36 (impairments and estimates)
Intangible assets	Yes	IAS 38, IAS 36 (impairments and estimates)
Non-current assets held for sale	Yes	IFRS 5
Financial assets (investments)	Yes	IFRS 9, IFRS 13 (fair value measurement)
Inventory	Yes	IAS 2 (NRV adjustments)
Trade and other receivables	Yes	IFRS 9 (ECL assumptions and estimates)
Cash & cash equivalents	Maybe?	
Contract assets	Yes	IFRS 15, IFRS 9 (change in rights and obligations)
Right of use assets	Yes	IFRS 16 (change in rights and obligations)

BALANCE SHEET PERSPECTIVE

LINE ITEM	2020 Impact?	IFRS Standard
BEE Share Scheme	Possibly	IFRS 2
Interest bearing loans	Maybe	IFRS 9
Provisions	Yes	IAS 40, IFRS 13
Contract Liabilities	Yes	IAS 36
Lease liabilities	Yes	IFRS 16
Define benefit plans	Yes	IAS 19

OTHER SIGNIFICANT AREAS TO CONSIDER

- **Statement of Profit & Loss**
  - Revenue recognition → IFRS 15
  - Government Assistance → IAS 20

- **Pervasive financial statement implications**
  - Going concern assumption → IAS 1
  - Material judgements and estimates → IAS 1
  - Post balance sheet events → IAS 10

IFRS 15
Revenue from Contracts with Customers

IFRS 15 – Where is the impact of COVID 19?

STEP 1: Identify the contracts with the customers

- The recognition criteria of collectability of the consideration entitled to need to be assessed for new contracts
- Contract modifications

STEP 3: Determine the transaction price

- Any form of variable consideration (estimates)
- Possible significant financing components

STEP 5:

- Recognition of goods and services may change depending on certain factors.

Core principle of IFRS 15

Entity recognises 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.

CONTROL

5 STEP APPROACH OF IFRS 15

- Step 1 – Identify the contract with the customer **(RECOGNITION)**
- Step 2 – Identify performance obligations in the contract. **(RECOGNITION)**
- Step 3 – Determine the Transaction Price **(MEASUREMENT)**
- Step 4 – Allocation of the transaction price to the performance obligation **(MEASUREMENT)**
- Step 5 – When & how should revenue be recognised (at a point in time or over a period of time)? **(RECOGNITION)**

STEP 1: Identify the contract with the customer

Step 1: Identify the contracts with the customers

Contract exists if ALL of following criteria are met:

- Parties to contract have **approved** contract **and committed to perform**
- Each party's **rights/obligations can be identified** (regarding transfer of goods/services)
- Identify **payment terms** for goods/services transferred
- Contract has **commercial substance** (risk, timing OR amount of future cash flows expected to change
- **Collection of consideration probable** (consider only the customer's ability and intention to pay)

A contract **does not exist** if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating (paying a penalty) the other party

Example: Collectability

A real estate developer enters into a contract with a customer for the sale of a building for R11 000 000. The customer intends to open a restaurant in the building. The customer has little experience in the restaurant industry. In addition, the COVID 19 lockdown regulations increases the uncertainty around the viability of the restaurant industry in the future.

The customer pays a non-refundable deposit of R110 000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 90% of the promised consideration as the customer does not have sufficient funds available to finance the transaction.

The financing arrangement is provided on a non-recourse basis, which means that if the customer defaults, the entity can repossess the building, but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed.

The customer obtains control of the building at contract inception in terms of the agreement.

- **Does a contract exist in terms of IFRS 15?**
- **How should the non-refundable deposit of CU50,000 be recognised?**

Example: Collectability (Solution)

1. The customer’s ability and intention to pay is in doubt due to following reasons:
   - Customer intends to repay loan from income derived from restaurant business (significant risks Due to COVID 19 lockdown and limited experience);
   - Customer lacks other income or assets that could be used to repay loan; and
   - Customer’s liability i.t.o loan is limited (non-recourse).

   To conclude, criteria is not met, and thus contract **does not exist** as it is not probable that entity will collect consideration it is entitled to in exchange for the building.

2. If criteria is not met and consideration is received it can be recognised as revenue if
   - the entity has no obligation to transfer goods or services and all of consideration promised by customer has been received and is non-refundable **or**
   - the contract has been terminated and consideration received is non-refundable **(IFRS 15.15).**

   Neither one of the criteria is met, thus can’t be recognised as revenue, should recognise as deposit liability.

Step 1: Contract modifications IFRS 15.18-21

- Change in scope or price of a contract when approved
- Approved – written, oral or implied business practice
- Accounting….
  - Prospectively (separate contract or termination of old contract and creation of new contract)
  - Retrospectively (cumulative catch-up)

Step 1: Contract modifications IFRS 15.18-21

Retrospective	Prospective	
Cumulative Catch-up	Separate Contract	Termination of old contract & creation of new contract
• No distinct goods/services • Assess contract as a whole	• Goods are distinct • Increase in price reflects the stand alone selling price of promised goods	• Remaining goods are distinct • Price change not reflecting stand alone selling price of remaining goods

Example: Contract modifications

On 1 January 2020, Ace Limited entered into a contract to sell 1 000 hand sanitising units over 12 months. Contract price R100 000. By end of March South Africa went into a nationwide lockdown to “flatten the curve”. On 31 March 2020, 700 units were delivered and the customer decided to order an additional 500 units (on top of 1 000) at R80 per unit. The reduced price is mainly due a refund because of the volume of the order and is therefore deemed to be an **extension of the existing contract**.

Solution:

Additional order: Output distinct but not at the stand alone price of R100 per unit. Therefore we must adjust price prospectively.

Revenue up to 31 March:
700@R100 = R70 000

After 31 March…..
300@R100 = R30 000
500@R80 = R40 000

Blended R70 000/800 = R87.50 per unit (prospective adjustment)

Example: Contract modifications (cumulative catch-up)

On 1 Jan 2020 Buildco Ltd entered into a contract to build an office park for R20 million. The R20 million included R15 million for the first phase and R5 million for the second phase. The estimated cost of the project was R14 million. The year end of Buildco Ltd is 30 June 2020.

R8 400 000 of the costs were actually incurred by 30 June 2014. On 30 June 2020 the customer decided to only keep phase 1 of the project as part of their cash management strategies in the COVID 19 outbreak. The decision meant that the contract price was reduced to R15 million on 30 June 2020 and the estimated cost of the project decreased by R2 000 000. The modification is deemed to be not distinct but an <u>extension</u> of the existing contract

Solution:

Revenue up to 30 June 2020:

8 400 000/14 000 000 x R20 000 000 = R12 000 000

After modification (cumulative catch-up par 21(b)):

8 400 000/12 000 000 x R15 000 000 = R10 500 000

Immediate adjustment to revenue = R1 500 000

STEP 2: Identify the performance obligations in the contract

Step 2: Identify the performance obligations in the contract

IFRS 15.22-29

At **contract inception**, assess goods and services **promised** and identify performance obligation as:

- Good or service (bundle of goods/services) that is **distinct** or
- Series of **distinct** goods or services that are substantially the same with **same pattern of transfer**

Step 2: Identify the performance obligations in the contract

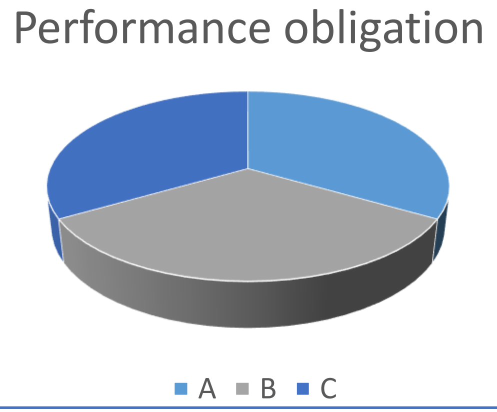
IFRS 15.22-29

A good or service promised is **distinct** if **both** of following criteria are met (IFRS 15.27):

- The customer can **benefit** from the good or service either **on its own or** together **with other resources that are readily available** to the customer (IFRS15.28).
- If an entity regularly sells a good or service separately it indicates that a customer can benefit from the good or service on its own or with other readily available resources.

+

The entity's promise to transfer the good or service to the customer is **separately identifiable from other promises** in the contract (IFRS 15.29).



Not separately identifiable in context of the contract IFRS 15.29

- Significant service of integrating the good or service with other goods or services promised in the contract into a **bundle of goods** or services that represent the **combined output** for which the customer has contracted.
  - In other words, input to produce combined output.

- the good or service significantly **modifies or customise** another good or service promised in the contract.

- the good or service is **highly dependent** or **highly interrelated** with, other goods or services promised in the contract.
  - For example, construction contract

STEP 3: Determine the transaction price

Step 3: Identify the performance obligations in the contract

IFRS 15.46-72

Transaction price – consider terms of contract and customary business practices

- Amount of consideration expects to be entitled to in exchange for goods or services
- Excludes amounts collected on behalf of third parties (VAT)
- Includes fixed and or **variable amounts**

Variable consideration

IFRS 15.50-59

Identify
- Assess the contract rights & obligations

Estimate
- Expected value or most likely amount

Constrain
- Look at factors in par. 57

Recognise
- After applying constraints

Estimating variable consideration

IFRS 15.53

- Estimate (on day 1) the amount of consideration to which the entity ***expects to be entitled to*** using either

Expected value	Most likely amount
• ***Probability-weighted*** amount in a range of outcomes • Most predictive where there are a large number of outcomes	• ***Single most likely amount*** in a range of outcomes • Appropriate where there are only 2 outcomes • E.g. performance bonus achieved or not

- It needs to have predictive value to the users of the financial statements

Constraining the estimates?

IFRS 15.56-57

Objective: Include variable consideration in the transaction price **only to the extent that**:

- it is **highly probable** that
- a **significant reversal** of revenue will **not occur** once the uncertainty is subsequently resolve

- 'Significant reversal' → Considered in relation to cumulative revenue recognised
- Requires consideration of both likelihood & magnitude

Constraining the estimates?

IFRS 15.56-57

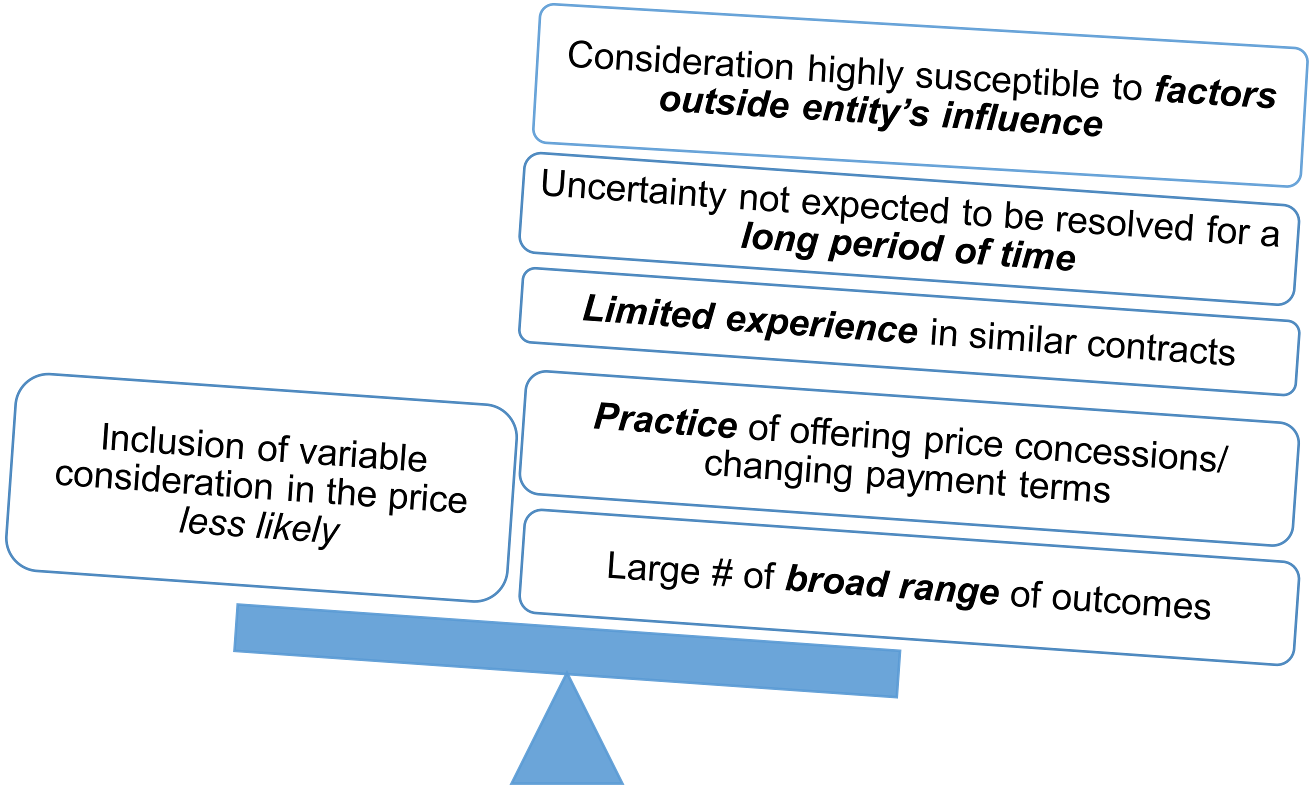
Objective: Include variable consideration in the transaction price **only to the extent that**:

- it is **highly probable** that
- a **significant reversal** of revenue will **not occur** once the uncertainty is subsequently resolve

- 'Significant reversal' → Considered in relation to cumulative revenue recognised
- Requires consideration of both likelihood & magnitude
- Need consider factors that will contribute to likelihood and magnitude of significant revenue reversals…. Next slide

Factors that could contribute to revenue reversal

IFRS 15.56-57



Sale with Right of Return

IFRS 15.B20-B23

A retailer will often sell a product and grant the customer the right to return the product in exchange for:

- Full/ partial refund in cash;
- Credit (e.g. gift card) that be applied against a future purchase; or
- Another product in exchange

Obligation to stand ready to accept returned goods is ***not a separate performance obligation*** (as opposed to service-type warranty)

Need to estimate the amount of consideration that the entity will be entitled to for the transfer of the goods and services.

Consider the COVID 19 impact: More returns could happened due to financial impact COVID 19 has on the consumers (customers). Need to reassess the estimates and appl the constraints in par. 56-57.

Sale with Right of Return

IFRS 15.B21

When recognising the sale, entity required to recognise:

1) Revenue (i.e. variable consideration) only to the extent of products it <u>expects NOT to be returned</u> (i.e. after having applied the constraint);
2) A refund liability; and
3) An asset (with a corresponding adj to CoS) representing the right to recover the products from the customer

Sale with Right of Return - Example

Cotton Inc. is a clothing retailer in South Africa. Cotton Inc. has a 31 December year end. Cotton Inc. sold 100 dresses during the month of December for R250 each (cost price R200) The

Cotton Inc. is has a returns policy that provides the customers with a right to return certain goods for a full cash refund if it is returned within 30 days after purchase date. Cotton Inc. expects 15 of the dresses will be returned by customers for a full refund

- Note that the returns are in terms of a returns policy offered by the store, the dresses are not defective
- Not an assurance warranty on defective products

Question

Prepare the journal entries that Cotton Inc. would record in respect of sales for the month of December

Sale with Right of Return - Example

On recognising the sale:

Dr – Bank	25 000	*(Receive cash from customers)*	
Cr – Revenue (P/L)		21 250	*(85 x R250)*
Cr – Refund liability (SFP)		3 750	*(15 x R250)*

Revenue limited to amount entity expects NOT to be returned which is the 85 dresses.

Recording the cost of sale/ Inventory movement

Dr – Cost of sales	17 000		*(85 x R200)*
Dr – Right of return asset	3 000		*(15 x R200)*
Cr – Inventory		20 000	*(100 x R200)*

Or

Dr – Cost of sales	20 000		*(100 x R200)*
Cr – Inventory		20 000	
Dr – Right of return asset	3 000		*(15 x R200)*
Cr – Cost of sales		3 000	

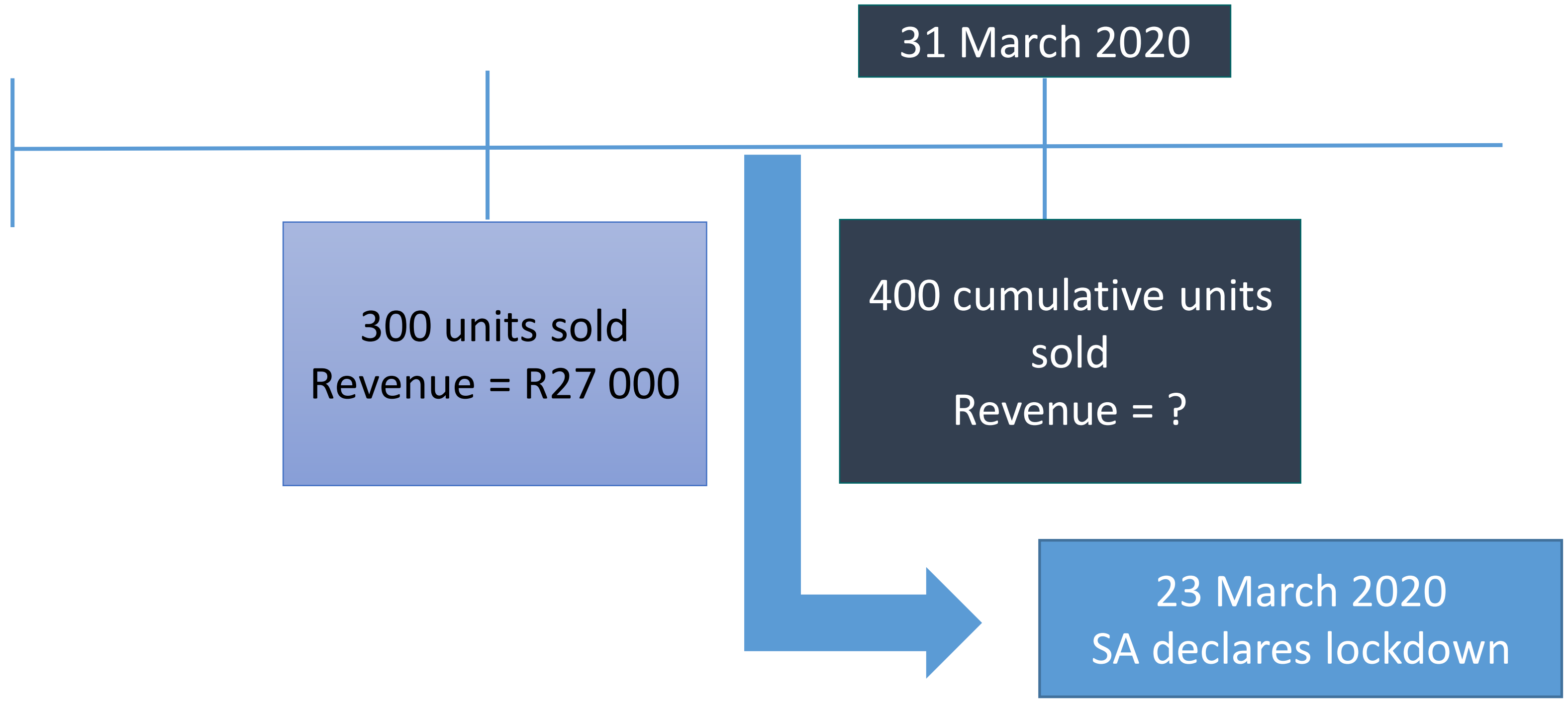
Volume Discounts - Example

ABC Ltd enters into a contract with a customer on 1 October 2019 to sell wine at R100 per bottle. If the customer purchases more than 1 000 bottles within the next 12 months, the contract specifies that the price per unit is retrospectively reduced to R90 per bottle. Consequently, the consideration in the contract is variable. The entity has a **30 September financial reporting** year end.

For the first quarter ended 31 December 2019, the ABC Ltd sells 300 bottles to the customer. ABC Ltd estimates that the customer's purchases will exceed the 1 000-unit threshold required for the volume discount in the 12-month period. ABC Ltd determines that it has significant experience with this product and with the purchasing pattern of the customer.

Revenue recognised (31 December 2019) → R27 000 (300 units × R90)

Volume Discounts - Example



Need to consider new facts at each reporting period and reassess the estimate made for variable consideration (IFRS 15.59)

Revenue for 31 March 2020 = (100 x 100) + (300 x 10) = R13 000

Significant Financing Components

IFRS 15.60-65

In some arrangements the timing of the payment of consideration price and transfer of goods and services occur at different times

Objective: To adjust the promised consideration for TVM to reflect the price the customer **would have paid** had he paid cash at the time that the G/S were transferred to him i.e. cash price on the date of **recognition**

Significant Financing Components

IFRS 15.60-65

- **How do you account for the Finance component?**
  - Not a separate performance obligation
  - Rather a component of variable consideration
- **Test:** Is there a **significant benefit** of financing to the customer?
    - Difference between PV and cash selling price
    - Length of time between payment and transfer of control over G/S
    - Interest rate in relevant market

Assess all facts & circumstances

- **Practical expedient**
  - Not required if payment terms are less than 1 year

- **Hot topic for COVID 19 with possible new contracts with "payment holidays" and "extended credit agreements".**

Significant Financing Component - Example

Accent (Pty) Ltd, a real estate development entity, enters into a contract with a customer for the construction of a residential complex on 1 January 2019. The residential complex is expected to take **2 years to complete** and will be handed over to the customers at the end of the contract (31 December 2020). It was determined that the contract does not meet the requirements of par.35 to be recognised over time and therefore the customer will take control at the end when completed **(recognised at a point in time).**

The payment terms required by the entity are as follows:

- **R500 000** payment as security deposit at the start of the project.
- **R2 500 000** payment transfer of **legal title at the end** of the project;
- **R1 000 000** after two years as part of a quality control clause in the agreement.

Accent (Pty) Ltd has a 31 December financial year-end. The market related interest rate applicable to the <u>entity without considering customer credit risk is 8%</u>. However, the market related interest rate applicable to the <u>entity considering customer credit risk is 10%.</u>

<u>REQUIRED</u>

What journal entries would the entity recognise for they years ending 31 December 2019 - 2022? For simplicity purposes use simple interest (1 x per year)

Significant Financing Component - Example

2019:		
Dr – Bank	500 000	
Cr – Contract Liability		500 000
2020		
Dr – Contract debtor (SFP)	826 446	
Dr – Contract Liability (SFP)	500 000	
Dr – Bank (SFP)	2 000 000	
Cr – Revenue (P&L)		3 326 446

(Solve for PV: FV: R1 million; n = 2 years; rate = 10% p.a.; NO pmt)

***Recognition** of revenue when **control** of bridge is **transferred** to customer = R2million plus R500 000 plus PV R826 446*

2021		
Dr – Contract debtor (SFP)	82 647	
Cr – Finance income (SPL)		82 647
2022		
Dr – Contract debtor (SFP)	90 909	
Cr – Finance income (SPL)		90 909
Dr – Bank (SFP)	1 000 000	
Cr – Contract debtor (SFP)		1 000 000

*(Interest income: PV of R826 446 x **10%** interest for one year)*

Interest income: Debtor carrying amount of R909 091 x 10% interest for one year

Significant Financing Components

IFRS 15.62

Significant financing component **does not exist** in the following situations:

- Customer paid for goods in advance and the timing of the transfer of goods is at the customer's discretion
- Substantial amount of consideration is variable in nature
- The difference between cash selling price and consideration is for reasons other than providing finance (protection against non-performance)

Apply judgment….

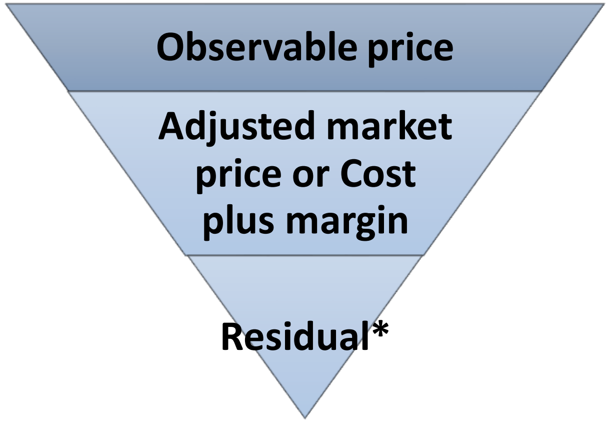
STEP 4: Allocate the transaction price to the identified performance obligations

Allocation of the transaction price

IFRS 15.73-78

- ✓ The number of distinct performance obligations have been identified **(STEP 2)**; and
- ✓ The transaction price has been determined **(STEP 3)**;
- ✓ NOW → **allocate** the transaction price to the performance obligations

- **<u>Objective of allocation</u>:** depict the amount of consideration that the entity **expects to be entitled to** in **exchange** for having transferred the promised **G/S**
- Allocation of the transaction price is done **based on stand alone selling price** (SASP) of **each PO**
  - Can be estimated if not directly observable.



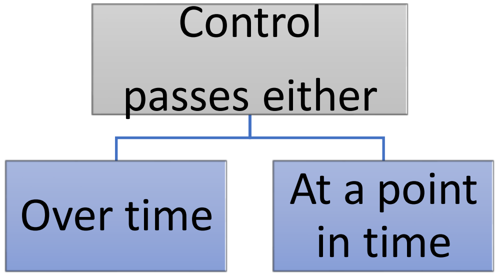
STEP 5: Recognise revenue when (or as) the performance obligation is satisfied

Recognition of revenue

IFRS 15.31-38

Principle

- An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer.
- An asset is transferred when (or as) the customer obtains control of that asset (IFRS 15.31 - 34).
- Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset
  - Includes ability to prevent others from gaining benefits or using asset.
- Fist “test” for over time recognition, if not, then recognize at a point in time….



Recognition of revenue over time…..

IFRS 15.35

Pure service	**Simultaneously receives and consumes** the benefits as the entity performs	Test → no need to substantially re-perform the work that the entity has completed to date.
Create/Enhance an asset	Customer **controls** as the asset is created or enhanced	Example → Construct a building on the client owned land (control over the WIP)
Create asset with no alternative use to entity	**And** the entity has an enforceable right to payment for performance completed to date	Example → Legal opinion, specialized equipment

How to recognize over time in terms of paragraph 35 (c) IFRS 15.B6-B13

Need to consider 2 aspects for recognition over time……..

1. ***No alternative use***

- Contractual Restrictions
- Practical limitation

2. ***Right to performance payment***

- Compensation for work completed to date
- Profit margin that reasonably reflects entity's performance
- Right to demand payment if customer terminates contract for reasons other than performance

Asset with alternative use - Example

An entity enters into a contract with a customer, a government agency, to build a specialised satellite. The entity builds satellites for various customers, such as governments and commercial entities.

The design and construction of each satellite differ substantially, on the basis of each customer’s needs and the type of technology that is incorporated into the satellite. It will require significant rework to make the satellite compatible with other customers’ systems and will have an adverse financial effect on the entity in doing so.

Government agency pays a deposit upon entering into the contract and the deposit is refundable only if the entity fails to complete construction of the specialised satellite in accordance with the contract. The remainder of the contract price is payable on completion of the contract when the government agency obtains physical possession of the satellite. If the government agency defaults on the contract before completion of the satellite, the entity only has the right to retain the deposit.

REQUIRED

Does the entity ‘qualify’ to recognise revenue over time in terms of IFRS 15?

Asset with alternative use - Example

Alternative use?

- The contract can transfer satellite to another customer, but would incur **significant costs to rework the design and function of the satellite** to direct that asset to another customer.
- Therefore, the asset has no alternative use because the **customer-specific design of the satellite limits** the entity's practical **ability to readily direct the satellite to another customer**.

Enforceable right to payment?

- Until construction of the unit is complete, the entity **only has a right to the deposit** paid.
- The entity **does not have an enforceable right to payment** for performance completed to date.

Thus it is not satisfied over time and therefore satisfied **at a point in time.**

Measuring progress towards completion (over time)

- In addition, to proving one of the three criteria, the entity must be able to prove that it can reasonably measure progress towards completion of the PO, if not there are certain limitations applied. (See example)

- In recognising revenue over time the entity will chose a method that ***best reflects*** the progress towards satisfying that PO (look at performance or value to customer)

Output methods

Measure progress by evaluating the extent of output delivered to date

E.g. engineer certificates, units produced etc..

Input methods

Measure progress by considering the entity's efforts/ inputs in satisfying the PO

E.g. costs incurred, machine hours lapsed etc..

Measurement of progress - Example

Bricco Ltd enters into a contract with a customer to build an office building. The contract start date is 1 January 2020 and is expected to last until end of 2022. Bricco Ltd has a 31 December financial year end.

The transaction price, as agreed upon by the parties is R10 000 000. The following payment schedule is applicable to the contract:

Milestone	Percentage of completion	Date achieved	Payment due:
Design and planning	10%	15 March 2020	R1 000 000
Structural certification	80%		R7 000 000
Final sign-off of occupancy	100%		R2 000 000

By 31 December 2020, the actual costs incurred to fulfil the contract was R3 400 000. The total budgeted costs for the project was estimated at R8 000 000. The costs are managed in such a way that it is deemed recoverable at any point in time.

REQUIRED

Journalise the transactions if Bricco uses an input measurement basis to measure progress on the project if:

a) By 31 December 2020, the COVID 19 impact made it impossible to determine the outcome of the project.

b) By 31 December 2020, all uncertainty was cleared and the initial estimations were still appropriate.

Measurement of progress – Example

Event a)	Event b)
15 March 2020 Dr Bank 1 000 000 Cr Contract Liability 1 000 000	**15 March 2020** Dr Bank 1 000 000 Cr Contract Liability 1 000 000
31 December 2020 Dr Contract Liability 1 000 000 Dr Contract Asset 2 400 000 Cr Revenue Recognised 3 400 000	**31 December 2020** Dr Contract Liability 1 000 000 Dr Contract Asset 3 250 000 Cr Revenue Recognised 4 250 000
Calculation:	**Calculation:**
10 000 000 x 3.4m/ 8m = **4 250 000**	10 000 000 x 3.4m/ 8m = **4 250 000**
However, get limited to the extent that expenditure was incurred and considered recoverable in the contract**.**	

At a point in time: Indicators of control (par 38)

Indicators that control has passed include a customer having:

- … a present obligation to pay
- … physical possession
- … legal title
- … risks and rewards of ownership
- … accepted the asset

Presentation & Disclosure

Presentation

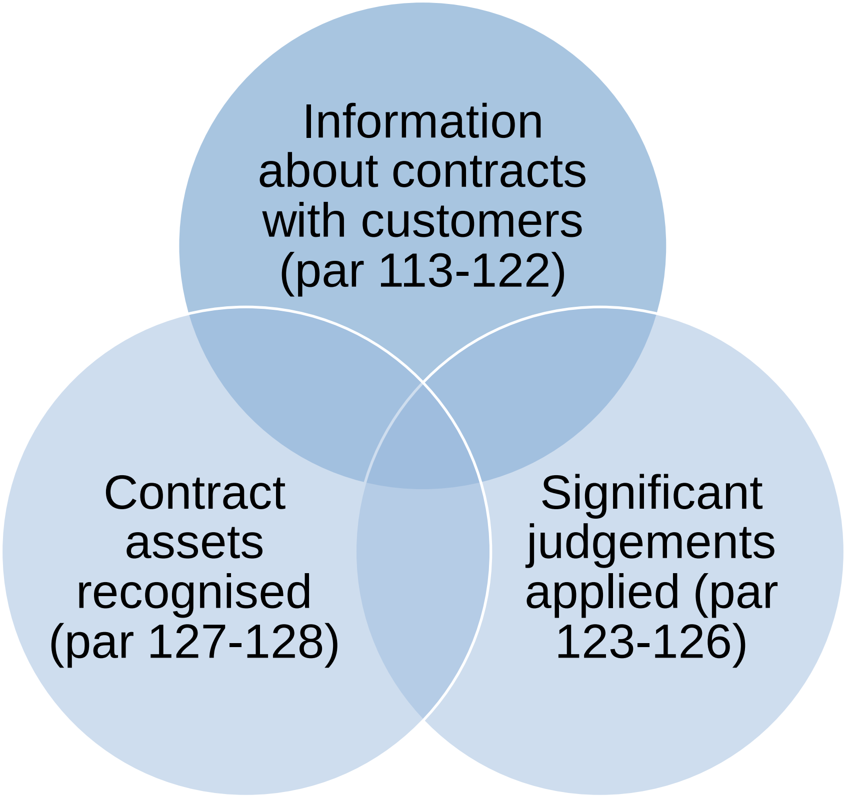
An entity shall present the contract in the statement of financial position as a contract asset or contract liability, depending on the relationship between the entity's performance and customer's payment.

No Performance = No Payment → Executory
Performance > Payment → Contract Asset
Performance < Payment → Contract Liability

An entity shall present any **unconditional rights to consideration** separately as a **receivable**. (IFRS 9)

Unconditional rights = only passage of time before payment of consideration is due.

Disclosure


Information about contracts with customers (par 113-122)
Contract assets recognised (par 127-128)
Significant judgements applied (par 123-126)

Disclosure practices from JSE Thematic Review

1. Accounting policies
    - Boilerplate (non-specific)
    - Not all revenue streams has accounting policy
2. Key judgments – are they disclosed?
    - Measuring progress to completion
    - Agent vs Principle
    - Modifications
    - Significant Financing Component
3. Specific disclosure requirements
    - Good disclosure on disaggregation of revenue
4. Misalignment between interim reporting and year-end reporting on IFRS 15.

IFRS 9
Financial Instruments

IFRS 9 – Where is the impact of COVID 19?

Classification of financial assets

- Change in business model?

Measurement

- The measurement of expected credit losses (ECL), whether it is on the general approach or simplified approach
  - Significant increase in credit risk
  - Forward looking information (prob default, loss of default, exposure

- Fair value measurement and disclosures (level 3)
- Modification of loans and other debt related instruments

Focus for the session

- Classification and reclassification
- Recognition and measurement
    - ECLs
    - Modification
    - Gains and Losses

Classification and reclassification

Classification of financial assets

An entity shall classify financial assets as subsequently measured at either *amortised cost (AC) or FVtPL or FVtOCI on the basis of both* (4.1.1)*:*

a) the entity's business model for managing the financial assets; and

b) the contractual cash flow characteristics of the financial asset.

Classification of Financial Assets

Are the contractual cash flows solely payments of principal and interest?

Yes

Is the business model to hold and collect cash flows only?

Yes → **Amort Cost**

No

Is the business model to collect cash flows and also by selling?

Yes → **FVtOCI (debt instruments)**

No → **FVtPL**

No

Despite par's 4.1.1–4.1.4, an entity <u>may, at initial recognition</u>, designate a financial asset as measured at FVtPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency

FVtPL
FVtOCI
(designate)

Classification of financial assets (debt instruments)

Manage & collect solely cash flows → AC

Manage & collect cash flows and business model to sell at any time → FVtOCI

Manage & collect FVs only → FVtPL

Classification of financial assets (equity instruments)

Cash flows and Business model = Manage fair values only

All equity investments

FVtPL

If not held for trading

Entity may elect: FVtOCI

Classification of financial liabilities

Norm → AC

Exception → FVtPL

Reclassification of financial assets (IFRS 9 4.4)

- When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets (4.4.1)
- Such changes are expected to be very infrequent (B4.4.1)
- Entity shall not reclassify any financial liability (4.4.2)
- If assets become hedging instruments it is not regarded as a reclassification (4.4.3)
- Reclassification date: First day of reporting period following the change in business model (Definition)

Is sale of assets under COVID 19 enough for change in business model?

Reclassification of financial assets (IFRS 9 4.4)

Considerations:

- An entity should consider the frequency and value of sales and whether these will be temporary in nature or continue into the future (for example, due to ongoing liquidity constraints).
- Sales may be consistent with a ‘hold-to-collect’ business model if those sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). (IFRS 9.B4.1.3B)
- An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with a ‘hold-to-collect’ business model if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity’s business model.

Reclassification of Financial Assets - Example

ABC Bank has a portfolio of loans that is held by companies within the tourism and hospitality industry. Due to COVID 19, a significant amount of loans had a significant increase in credit risk. The management of ABC Bank has decided to sell off these loans due to the higher risk of default on these loans. Management has mentioned that this will be the new business model for the near future since COVID 19 has impacted the bank significantly. Management wants to manage the fair values of the loans to meet the liquidity needs in the short term.

Management now suggested that the portfolio of loans need to be reclassified from held at amortised cost to held at fair value through other comprehensive income (OCI).

REQUIRED

Can ABC Bank reclassify their financial assets at amortise cost to held at fair value through OCI.

Reclassification of Financial Assets - Example

Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows. Sales would not contradict that objective if they were in response to an increase in the assets' credit risk, for example if the assets no longer meet the credit criteria specified in the entity's documented investment policy.

Therefore the portfolio of loans **should not** be reclassified in terms of IFRS 9.

Reclassification of financial assets (IFRS 9 4.4)

AC to FVtPL	FV	Difference to P/L
FVtPL to AC	FV	FV becomes CA
AC to FVtOCI	FV	Difference to OCI
FVtOCI to AC	AC	Trf G/Ls to CA
FVtPL to FVtOCI	FV	Future G/Ls to OCI
FVtOCI to FVtPL	FV	Reclassify OCI to P/L

Recognition and measurement

Recognition and initial measurement

RECOGNITION

When the entity becomes a part to the contract

INITIAL MEASUREMENT (5.1.1)

- All FAs (Except trade receivables) and FLs at fair value
- Add transaction costs to FA's (except for FVtPL will be accounted for in P/L)
- Deduct transaction costs from FL's (except for FVtPL will be accounted for in P/L)
- Transaction costs for items at If FV differs from transaction price, recognise gain or loss in terms of B5.1.2A (5.1.1A)
- Remember shareholders loan with no interest (IFRS9:5.1.1, B5.1.1)
- Fair value determined using IFRS 13 principles
- Trade receivables, without a financing

Initial Recognition - Example

A director borrowed R500 000 from company at 0% interest. The loan is repayable in full in 3 year's time. However, there are no fixed payment terms for the loan other than paying the full outstanding balance at the end of 3 years. The fair interest rate on similar loans (observable) was 10% when the contract was effective.

REQUIRED

Provide the journal entries for the first year of recognizing the loan in the accounting records of Z Ltd.

Solution: Shareholders loan with no interest

Calculation of fair value:

FV 500 000, I=10%, PMT=0, N=3, Compute PV= 375 657

Amort	Open	Int	Pmt	Closing
1	375 657	37 566	0	413 223
2	413 223	41 322	0	454 545
3	454 545	45 455	0	500 000

Loan asset	375 657	
Loss at initial recognition (P/L)	124 343	
Bank		500 000
Loan asset	37 566	
Interest received (P/L)		37 566

Subsequent measurement of financial assets

- Shall measure a financial asset at: (5.2.1)
  1) Amortised cost;
  2) FV through OCI; or
  3) FV through PL

- Based on initial classification.
- Shall apply the impairment requirements to financial assets measured at amortised cost in terms of par 4.1.2 and at FVtOCI in terms of 4.1.2A (5.2.2).
- Shall apply the hedge accounting requirements in terms of par 6.5.8-14 to a financial asset that is designated as a *hedged item* (5.2.3)

Subsequent measurement of financial liabilities

- Shall apply 4.2.1 – 4.1.2 = Amortised cost or at FVtPL (5.3.1)

- Shall apply the hedge accounting requirements in terms of par 6.5.8-14 to a financial liability that is designated as a *hedged item* (5.3.2)

Modification of liabilities

- **Hot topic** for current COVID 19 environment, need to consider:
  - Debt relief modifications
  - 10% test
  - Consider qualitative information
- If modification is substantial, then the asset need to be extinguished
- If not, then future contractual cash flows need to be PV and adjustment need to be made similar to modification of financial asset.

Modification of financial liability (substantial modification)

Asset need to be extinguished in terms of IFRS 9 B3.3.2

- The difference between the carrying amount of the financial liability extinguished and the consideration paid, including any non-cash assets transferred or liabilities assumed, is recognised in profit or loss
- Any costs or fees incurred are recognised as part of the gain or loss on extinguishment and do not adjust the carrying amount of the new liability
- The new debt instrument is initially recognised at fair value

Amortised Cost (Financial Asset)

- Interest revenue: Apply effective interest rate to the gross carrying amount (before recognised credit losses) (5.4.1) except for:
  - Purchased credit impaired assets: By applying the credit-adjusted effective interest rate to the AC from initial recognition
  - Not credit impaired originally, but became credit impaired subsequently: Apply effective interest rate to the AC in subsequent periods
- Reverse to gross carrying amount if no longer credit-impaired (5.4.2)
- Consider impairment through expected credit loss model (next slide)

Subsequent measurement - impairment

Two methods of accounting for impairments through expected credit losses:

General Approach

Simplified approach

Hot topic on IFRS 9, especially in the current COVID 19 environment.

Write-off (5.4.4)

Shall directly reduce the entire or portion of the gross carrying amount if no reasonable expectation to recover FA

Subsequent measurement - impairment

General approach to *expected* credit losses

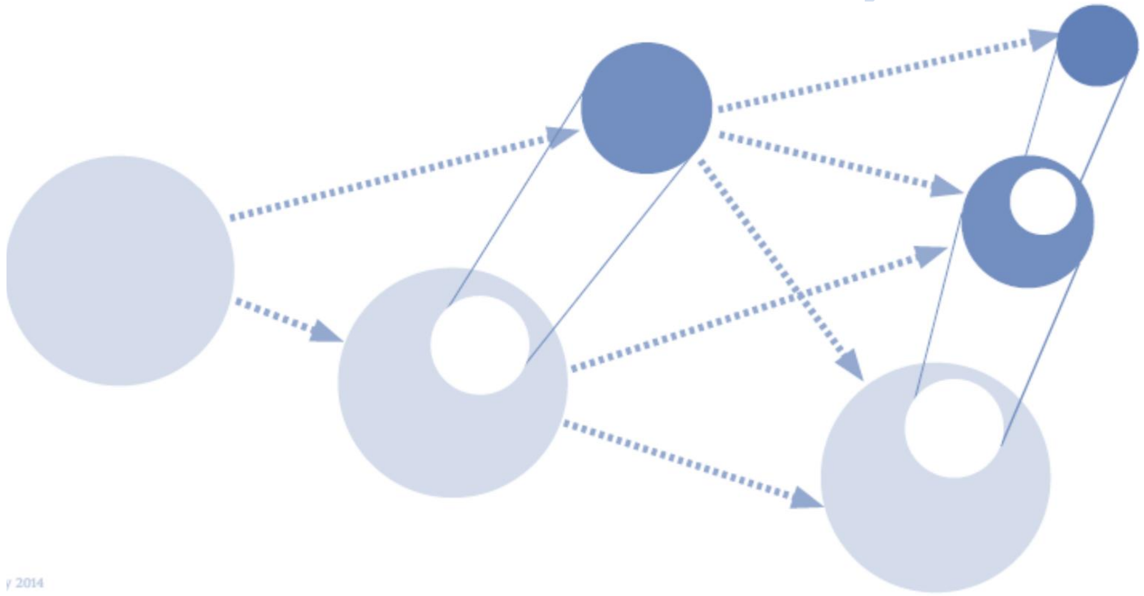
- Shall recognise a loss allowance on a financial asset that is measured at AC in 4.1.2 (5.5.1)
- Financial asset at FVtOCI (4.1.2A) – loss allowance will be included in OCI (5.5.2)
- At each reporting date, shall measure the loss allowance equal to the *life time expected credit losses* (LTECL) if credit risk increased significantly since initial recognition (5.5.3)
- If credit risk did not increase significantly since initial recognition, measure loss allowance equal to the *12 month expected credit losses* (12MECL) (5.5.5)
- Shall measure loss allowance at 12MECL if LTECLs are not expected – difference shall be adjusted in the PL (5.5.7-8)

General ECL model

Low credit risk, no increase since initial recognition	**Allowance:** **= 12MECL**
Higher credit risk, significant increase since initial recognition	**Allowance:** **= LTECL**
Objective evidence, credit impaired	**Impairment loss:** **Like modified cash flows** **(Subsequent: Effective interest on AC)**

General ECL model (process)

Stage 1 → Stage 2 → Stage 3



Amortised Cost: Loss Allowance and Subsequently credit impaired

Company invests in R10 000 10% bond at R9 600 (FV) and incurred transaction cost R200 = R9 800. Redeemable in 5 years at 10% premium. Bond was not credit impaired initially. Initially a loss allowance of R250 based on the 12MECL was provided. At the end of year 1 the credit risk increased and the LTECL was estimated to be R600. The Bond became credit impaired at the end of year 2 when the entity was of opinion that the bond will be redeemed at nominal value and that the term will be adjusted from 5 to 10 years in the future. JE's for Y1-3.

PV=-9 800, pmt=1 000, n=5, FV=11 000, comp i=12.127% . (eff. interest rate)

	PMT	Interest	Capital	Gross CA
End		12,127%		9 800
1	1 000	1 188	188	9 988
2	1 000	1 211	211	10 200
3	1 000	1 237	237	10 437
4	1 000	1 266	266	10 702
5	1 000	1 298	298	11 000

Pmt=1000, n=8, i=12.127, FV=10000, Comp PV end of Y2 ? = 8 948.

Impairment Loss: 10 200 – 8 948 = R1 252.

Amortised Cost: Subsequently credit impaired (CONTINUED)

Subsequent years:

In the 8 subsequent years the effective interest rate of 12.127% will be applied to the amortised cost value of R8 948.

See below:

Year	Open	Interest	Pmt	Capital	Amort Cost
3	8948	1085	-1000	85	9033
4	9033	1095	-1000	95	9129
5	9129	1107	-1000	107	9236
6	9236	1120	-1000	120	9356
7	9356	1135	-1000	135	9490
8	9490	1151	-1000	151	9641
9	9641	1169	-1000	169	9810
10	9810	1190	-1000	190	10000

Year 1		
Bond (At AC) (9600 + 200)	9 600	
Bank		9 600
Expected Impairment loss (P/L)	250	
Loss Allowance (SFP)		250
Bank	1 000	
Bond (At AC)	188	
Interest received (P/L)		1 188
Expected Impairment loss (P/L)	350	
Loss Allowance (SFP) (600-250)		350
Year 2		
Bank	1 000	
Bond (At AC)	211	
Interest received (P/L)		1 211
Impairment loss (P/L)	652	
Loss Allowance (SFP)	600	
Bond (At AC)		1 252
Year 3		
Bank	1 000	
Bond (At AC)	85	
Interest received (P/L Based on R8 948)		1 085

General approach – stages

Determining increases in credit risk (5.5.9-11)

- At each reporting date: assess change in risk of default occurring over expected life
- Use reasonable and supportable forward-looking information
- Past information if contractual payments are more than 30 days overdue **(rebuttable presumption)**

General approach – measurement of ECL

- Losses that might result from possible default events
- Default should be defined consistent with internal risk management practices of the entity (B5.5.37)
- Measure in a way that reflects (5.5.17):
  - ➢An unbiased and probability-weighted amount determined by evaluating possible outcomes
  - ➢Time value of money.
  - ➢Reasonable and supportable information – **past, current and future**
- Possibility that no credit losses will occur vs possibility that credit loss will occur (5.5.18, B5.5.41)
- Over the maximum contractual period (including extension options) (5.5.19)
- Difference between PV of contractual cash flows and cash flows expected to be received (B5.5.29)

Simplified approach

- Simplified approach, <u>if no significant financing component included</u>
  - such as trade receivables and shot term contract assets
- Measure loss allowance equal to the LTECLs (5.5.15)
- Entity shall elect accounting policy for receivables (5.5.16)
- Provision matrix - based on number of days outstanding and historical experience (B5.5.35)
- Taking into account diversity of customer base (B5.5.35)

Simplified approach steps

1. Need to group certain financial assets (debtors) into certain groups or segments (age analysis).
   - Could also segment based on geographical region or sector
2. Need to determine the default rates
   - Historical information
   - Adjust for forward-looking information (COVID 19)
3. Refer back into your age analysis (reasonable period) and analyze trends
4. Then adjust for forward looking information
   - How does COVID 19 impact consumer spending
   - Inflation?
   - Unemployment?

Example: Bad debt “provision” – “loss allowance”

Kingston Ltd, a trading company, has **trade receivables** with gross carrying amount of R500 000 at the end of Y2. The balance of the allowance for credit losses was R9 100 at end of Y1. Careful analysis of the trade receivables showed the following:

Past due days	Amount in R	% of expected credit loss
Within maturity	392 200	0.50
1-30 days	52 300	0.80
31-90 days	27 600	5.60
91-180 days	13 200	8.90
181-365 days	7 500	20.30
365+ days	5 000	70.00
Debtor A	2 200	100.00
Total	**500 000**	**n/a**

One of Kingston’s customers, debtor A, filed for bankruptcy proceedings during Y2. Kingston’s receivable to debtor A amounts to R2 200 and Kingston expects to recover close to nil. The last column of the table contains percentages of expected credit loss in the individual aging groups. Kingston estimated these percentages based on the historical experience and adjusted it, where necessary, for forward-looking estimates.

How should Kingston calculate loss allowance in line with IFRS 9?

Example: Bad debt “provision” – “loss allowance”

The loss allowance is calculated as:

(392 200 x 0.5%) + (52 300 x 0.8%) + (27 600 x 5.6%) + (13 200 x 8.9%) + (7 500 x 20.3%) + (5 000 x 70%) = R10 122.30.

JE in Y2:

Expected for credit losses (PL) (R10 122 - R9 100)	1 022	
Allowance for credit losses (SFP)		1 022

Example: Loss rate approach

Queen Ltd wants to calculate the impairment loss of its trade receivables as of 31 December 2019. Queen's policy is to give 30 days for the repayment of receivables. Therefore, there is NO significant financing component. The aging structure of trade receivables as of 31 December 2019 is as follows together with payment information relating to historical trends on the total sales value of R20 000 000:

Age	Amount (R'000)	Paid Amount	Paid Amount (cumulative)	Unpaid Amount	Comment
Current	800	7 500	7 500	12 500	
31-60 days	350	6 800	14 300	5 700	
61-90 days	280	3 000	17 300	2 700	
91-120 days	170	2 200	19 500	500	
>120 days	100		19 500	500	Written off
	1 700	**19 500**	**19 500**		

How should Queen calculate loss allowance in line with IFRS 9?

Example: Loss rate approach (calc loss rates)

Firstly, you need to calculate the loss rates based on the historical data….

The loss in relation to the unpaid amount in each "bucket"

Age	Amount (R'000)	Paid Amount	Paid Amount (cumulative)	Unpaid amount	Loss rate
Current	800	7 500	7 500	20 000	2.5%
31-60 days	350	6 800	14 300	12 500	4.0%
61-90 days	280	3 000	17 300	5 700	8.8%
91-120 days	170	2 200	19 500	2 700	18.5%
>120 days	100		19 500	500	100%
	1 700	**19 500**	**19 500**		

The unpaid amount at the start of each "bucket" since payment was received in bucket.

Secondly, you need to adjust for forward looking information….. Next slide

Example: Loss rate approach (forward looking info)

In taking forward looking information into account, the company did a detailed analysis using a Monte Carlo model to incorporate the effect of unemployment in SA on the expected loss rate. It was determined that the loss rate for each “bucket” need to increase by 10% based on information in the post COVID 19 economy.

Age	Amount (R’000)	Paid Amount	Paid Amount (cumulative)	Unpaid amount	Loss rate	Adjusted Loss Rate
Current	800	7 500	7 500	20 000	2.5%	2.75%
31-60 days	350	6 800	14 300	12 500	4.0%	4.4%
61-90 days	280	3 000	17 300	5 700	8.8%	9.6%
91-120 days	170	2 200	19 500	2 700	18.5%	20.4%
>120 days	100		19 500	500	100%	100%
	1 700	**19 500**	**19 500**			

Example: Loss rate approach (final calculation)

Now, calculate the expected credit loss, using the loss rates calculated in the previous steps by applying it to the outstanding balance at 31 December 2019.

Age	Amount (R'000)	Adjusted Loss Rate	ECL
Current	800	2.75%	22
31-60 days	350	4.4%	15.4
61-90 days	280	9.6%	26.9
91-120 days	170	20.4%	34.7
>120 days	100	100%	100
Total	**1 700**		**199**

Dr Expected Credit Loss (P/L) R199 000

Cr Expected Credit Loss Allowance (SFP) R199 000

Modification of financial assets

- **Hot topic** for current COVID 19 environment, need to consider:
  - Debt relief modifications
  - Consider if asset should be derecognized in terms of IFRS 9
  - Consider qualitative information

- If modification is substantial, then the asset need to be derecognized in terms of IFRS 9 3.2.3 (derecognition of financial assets)
- If not, then future contractual cash flows need to be PV and adjustment need to be made.

Modification of financial assets (non-substantial modification)

Modification of contractual cash flows (5.4.3) – *similar to FA that became credit impaired*

- If cash flows are renegotiated or modified: PV using the original effective interest rate
- Any difference with carrying amount: Recognise gain or loss in PL
- Adjust carrying amount and effective interest rate for any costs or fees

Amortised cost: Modified cash flows

Company invests in R10 000 10% bond at R9 600 (FV) and incurred transaction cost R200 = R9 800. Redeemable in 5 years at 10% premium. Bond was not purchased or originated credit impaired.

PV=-9 800, pmt=1 000, n=5, FV=11 000, comp i=12.127%.

	PMT	Interest	Capital	Gross CA
End		12,127%		9 800
1	1 000	1 188	188	9 988
2	1 000	1 211	211	10 200
3	1 000	1 237	237	10 437
4	1 000	1 266	266	10 702
5	1 000	1 298	298	11 000

At end of year 1 the cash flows were renegotiated due to COVID 19 implications.

The bond will be redeemed at par and not at a premium of 10%.

Pmt=1000, n=4, i=12.127, FV=10000, Comp PV? = 9 356.

Modification loss: 9 988 – 9 356 = R632

Amortised cost: Modified cash flows (CONTINUED)

Subsequent years:

In the 4 subsequent years the **original** effective interest rate of 12.127% will be applied to the adjusted gross carrying amount/AC of R9 356

See below:

Year	Open	Interest	Pmt	Capital	Amort Cost
2	9356	1135	-1000	135	9491
3	9491	1151	-1000	151	9642
4	9642	1169	-1000	169	9811
5	9811	1189	-1000	190	10000

Gains and losses in IFRS 9

All gains and losses measured at fair value shall be recognised in P/L (5.7.1)
EXCEPT

Equity instrument not held for trading (elected 5.7.5)

Debt instrument held for cash flows and sale (4.1.2A)

OCI

Effects of changes in own-credit risk if

Financial Liab. @ FVtPL

Part of an hedging relationship –

Cash flow hedges

Gains And Losses: Debt Instrument

On 1 January 2019 a company purchased a 7% bond with a face value of R10 000 for R9 792, which is also the fair value.

The bond matures in 10 year's time at a 10% premium.

Effective interest rate: FV=11 000, n=10, P=700, PV=9792, i ?=8%

Balance sheet date : 31 December , Ignore taxes

REQUIRED: Show journal entries for 2019 and 2020

A: Company classifies bond as “Measured at FVtOCI” (Par4.1.2A)
B: Company classifies bond as “Measured at FVtPL” (Par 4.1.4)

Fair values are as follows:

31-12-19	10 020
31-12-20	10 150

A: Fair value through other comprehensive income

	Open	Int 8%	Pmt	Closing
19	9792	783	-700	9875
20	9875	790	-700	9965
21	9965	797	-700	10063
22	10063	805	-700	10168
23	10168	813	-700	10281
24	10281	822	-700	10404
25	10404	832	-700	10536
26	10536	843	-700	10679
27	10679	854	-700	10833
28	10833	867	-700	11000

		Dr	Cr
2019			
Investment at FVtOCI		9 792	
Bank			9 792
Bank		700	
Investment at FVtOCI		83	
Interest received (P/L) (Fully taxable)			783
Investment at FVtOCI		145	
MtM (OCI)	10020-9875		145
2020			
Bank		700	
Investment at amortised cost		90	
Interest received (PL) (Fully taxable)			790
Investment at FVtOCI		40	
MtM (OCI)	10150-9965-145		40

B @ Fair Value through PL

2019

Investment at FV		9 792	
	Bank		9 792
Bank		700	
	Investment at FV		700
Investment at FV		928	
	Gains on Inv (P/L)		928
	10 020	-9 092 (9 792-700)	

2020

Bank		700	
	Investment at FV		700
Investment at FV		830	
	Gains on Inv (P/L)		830
	10 150	-9 320 (10 020-700)	

IFRS 16
Leases

IFRS 16 – Where is the impact of COVID 19?

Measurement

- Modifications due to rent concessions provided to the lessee during COVID 19
- Impairments of Right of Use Assets

Focus for the session

- Identification
- Lease exemptions
- Recognition and measurement of lessee accounting
- Lease modifications and reassessments

Identification of a lease

Identifying a lease

At inception of a **contract**, an entity shall assess whether the contract is, or contains, a **lease**

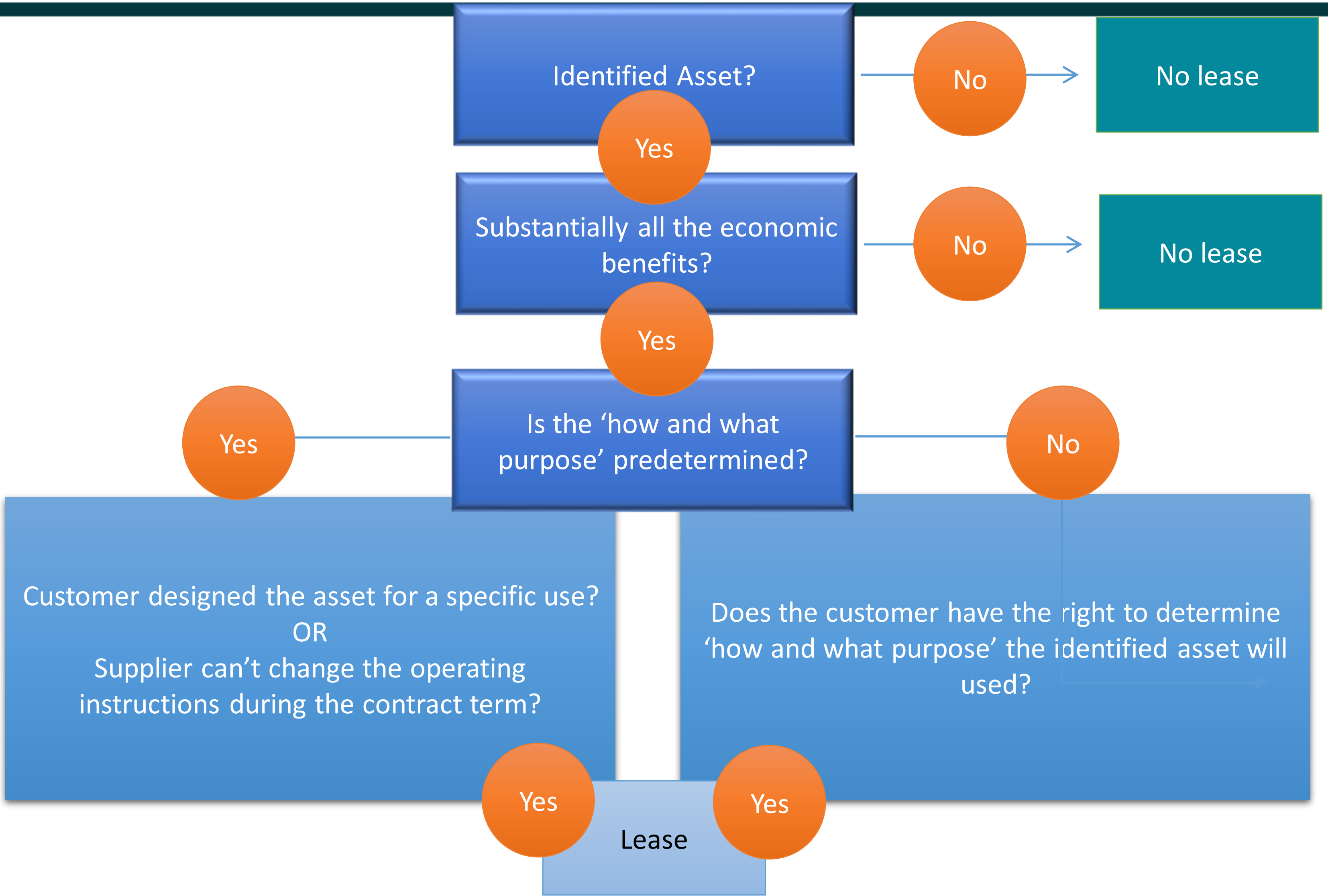
It will be a lease if **ALL** of the following exists (per definition):

- It conveys the **right to control**
- An **identified asset**
- For a period of **time**
- In exchange for **consideration**

Identifying a lease

- **Identified asset?**
  - Consider substitution rights of lessor (need to be practical and benefit exceed cost)
  - Portion allowed if physically distinct
- **Substantially all economic benefits?**
  - Directly or indirectly
  - Within scope of the arrangement
- **Right to control use?**
  - Decision making rights (when, what, how many, price etc)

Identifying a lease – B31



Identifying a lease – IASB Example

Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use three specified, physically distinct dark fibres within a larger cable connecting Hong Kong to Tokyo.

Customer makes the decisions about the use of the fibres by connecting each end of the fibres to its electronic equipment (i.e. Customer 'lights' the fibres and decides what data, and how much data, those fibres will transport).

If the fibres are damaged, Supplier is responsible for the repairs and maintenance. Supplier owns extra fibres, but can substitute those for Customer's fibres only for reasons of repairs, maintenance or malfunction (and is obliged to substitute the fibres in these cases).

REQUIRED

Is this a lease in terms of IFRS 16?

Identifying a lease – IASB Example

- Asset explicitly specified in contract?
- Substitution rights?
- Right to obtain economic benefits from use?
  - Within contract limits/scope
  - Cash flows paid to supplier
- Right to direct the use
  - Decision-making rights

This agreement contains a lease

Lease exemptions

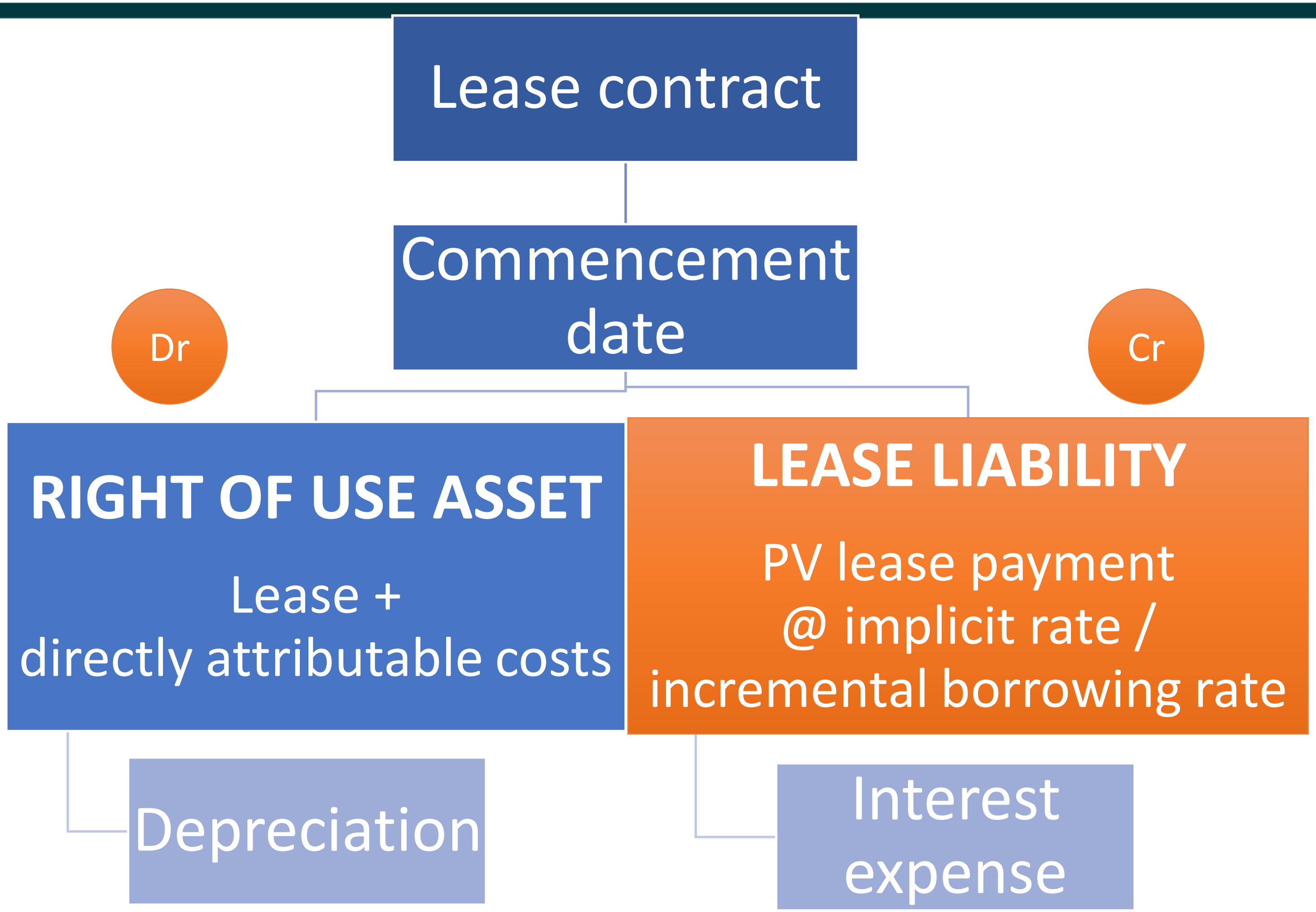
Accounting for lease exemptions

- Elect not to apply IFRS 16 requirements **(par. 6)**
  - Short-term leases (<12 months) OR
  - Underlying asset is low-value (Para B3-B8)
    - ➢ *New asset value (disregard age)*
    - ➢ *Don’t consider materiality of the entity*
    - ➢ *Examples of low value – tablets, computers, small furniture etc.*

- Recognise lease payment on a straight-line basis over lease term (similar to IAS 17)
- Expense to P/L
- When modified – will be treated as a new lease

Recognition and measurement

Accounting for lease exemptions



Initial recognition and measurement

- Measure on commencement (lease start) date
  - The date that lessee becomes entitled to **exercise** its **right to use** the leased asset
    - Not the date that you enter into agreement

- **Essentially:** PV of all future contractual payments likely to incur which can be measured reliably on commencement of lease
- Present value of the lease payments that are NOT paid (**future payments**) at that date
- Re-measure on an ongoing basis if changes occur in the contractual terms.

Inputs affecting the measurement of lease liability

Lease period (par 18-21)

- Non-cancellable period of a lease plus:
  - Extension periods (if likely to exercise);
  - Termination periods (if likely will not exercised)
- Definitions in the appendix A

Discount rate (par 26)

- Rate implicit in agreement OR *if unavailable*
- Incremental rate of borrowing

n

i

Additional guidance on the lease period

n

- Total period for which lease contract is **enforceable** (B34)
- Not enforceable if
  - Can terminate without permission op other party
  - Minimal penalty on cancellation

- Includes rent-free periods (B36)

- Para B37 provides guidance on how to determine of it is likely that termination and extension options will be exercised **(economic incentive)**

- Use past practice and other available information

Inputs affecting the measurement of lease liability

Lease payments (par 27)

- Fixed payments = unavoidable (contract)
  - In substance fixed payments **(B42)**
- Variable ONLY IF / to extent based on observable index or rate (e.g. inflation)

PMT

- Other amounts if **likely to incur**: purchase options + termination penalties
- End of lease payments / guaranteed residual values
- Cancellation penalties (if intend to cancel)

FV

Right of use asset (par 23 -25)

- Measure on commencement (lease start) date
- Measured at COST (similar to IAS 16)

Initial measurement of liability (*para 26 - 28*) + *Ay lease payments made at or before the commencement date* − Any lease incentives (defined term – App A) + Initial direct costs (similar to IAS16) + dismantling / site restoration (similar to IAS16; measure per IAS 37)

Subsequent measurement of RoU Asset (par 29-35)

Apply a cost model

- ✓ Depreciate asset (*per IAS 16 guidance*) and apply IAS 36 if asset is impaired
- ✓ Remeasurement [if liability remeasured]

Useful life?

1. If ownership transfer/expects to transfer = UL of asset **OR**
2. Other lease arrangements = shorter of lease term or UL of asset being leased

Not a cost model?

- Leasing an investment property and apply a fair value model to other investment properties (IAS 40)
- Similar class of PPE asset is revalued (elect to apply) revaluation model

Remeasurements and modifications

Lease remeasurement vs lease modification

- Are the change in the terms based on the **original contract?**
  - **Yes →** Lease reassessment (option to extend etc)
  - **No →** Lease modification (new scope changes)

IASB COVID 19 Amendment

- Make it easier for lessees to account for COVID 19 related rent concessions such as rent holidays and temporary rent reductions
- The amendment exempts lessees from having to consider individual lease contracts to determine whether rent concessions occurring as a direct consequence of the COVID 19 pandemic are lease modifications and allows lessees to account for such rent concessions as if they were not lease modifications
- It applies to COVID 19 related rent concessions that reduce lease payments due on or before 30 June 2021

IASB COVID 19 Amendment – Practical Expedient

- The practical expedient applies **only** to rent concessions occurring as a direct **consequence of the COVID 19 pandemic** and only if all of the following conditions are met:
  a) 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**
  b) any reduction in lease payments affects only payments originally **due on or before 30 June 2021** and
  c) there is **no substantive change to other terms and conditions** of the lease

IASB Illustrative Example – COVID 19

Fact pattern
At 31 March 2020 a lessee has a lease liability of CU2,000. The contract requires monthly lease payments of CU100.
For simplicity, it is assumed in all scenarios that (i) interest accrues at CU20 per month; and (ii) a reduction of CU100 in one month followed by an increase of CU100 in a later month is considered to affect only the timing of payments. The analysis below sets out the accounting for the lease liability in four scenarios: the first where there are no changes to the lease payments and three scenarios where the fact pattern is adjusted in the manner described. Accounting for the right-of-use asset is not included.

No change in lease payments	**Forgiveness of lease payments** *Mar–May 2020: no lease payments*	**Deferred lease payments** *Mar–May 2020: no lease payments* *June–Aug 2020: lease payments CU 200*	**Partially deferred, partially forgiven lease payments** *Mar–May 2020: no lease payments* *June–Aug 2020: lease payments CU 160*
In 3-month period, March – May 2020 Dr lease liability (100*3) 300 Cr cash 300 Dr interest (P&L) (20*3) 60 Cr lease liability 60	**In 3-month period, March – May 2020** Dr lease liability (100*3) 300 Cr P&L 300 *(negative variable payments)* Dr P&L (interest) 60 Cr lease liability 60	**In 3-month period, March – May 2020** - - Dr interest (P&L) 60 Cr lease liability 60	**In 3-month period, March – May 2020** Dr lease liability (40*3) 120 Cr P&L 120 *(negative variable payments)* Dr P&L (interest) 60 Cr lease liability 60
Lease liability at 31 May 2020: CU 1,760	**Lease liability at 31 May 2020: CU 1,760**	**Lease liability at 31 May 2020: CU 2,060**	**Lease liability at 31 May 2020: CU 1,940**
In 3-month period, June – Aug 2020 Dr lease liability (100*3) 300 Cr cash 300 Dr interest (P&L) 60 Cr lease liability 60	**In 3-month period, June – Aug 2020** Dr lease liability (100*3) 300 Cr cash 300 Dr P&L (interest) 60 Cr lease liability 60	**In 3-month period, June – Aug 2020** Dr lease liability (200*3) 600 Cr cash 600 Dr interest (P&L) 60 Cr lease liability 60	**In 3-month period, June – Aug 2020** Dr lease liability (160*3) 480 Cr cash 480 Dr P&L (interest) 60 Cr lease liability 60
Lease liability at 31 August 2020: CU 1,520	**Lease liability at 31 August 2020: CU 1,520**	**Lease liability at 31 August 2020: CU 1,520**	**Lease liability at 31 August 2020: CU 1,520**

Lease remeasurement vs lease modification

- Are the change in the terms based on the **original contract?**
  - **Yes →** Lease reassessment (option to extend etc)
    - Adjust **both** liability and right to us asset
    - Need to calculate revised discount rate if lease terms has changed or purchase options used
  - **No →** Lease modification (new scope changes)

    Separate lease if:
    - the modification increases the scope of the lease by adding one or more assets, and
    - the lease consideration is increased by an amount commensurate with the stand-alone price for the increase in scope, and any related and appropriate adjustments to that price

Comprehensive Example (IASB)

On 1 Jan 20x1, Alpha enters into a **10-year lease** of a floor of a building with an option to extend the lease for a further five years. The lease payments are R50 000 per year during the initial term and R55 000 per year during the optional period, all payable at the beginning of each year.

To obtain the lease, Alpha incurs initial direct costs of R25 000, of which R20 000 relates to a payment to a former tenant occupying the floor of the building and R5 000 relates to the commission paid to the real estate agent that arranged the lease.

As an **incentive** to Alpha for entering into the lease, the lessor agrees to reimburse Alpha the real estate commission of R5 000 and Alpha's leasehold improvements of R7 000.

At the commencement of the lease, Alpha concludes that it is ***not* reasonably certain to exercise the option to extend the lease**. The interest rate implicit in the lease is not determinable. Alpha's incremental borrowing rate is 5% per annum which reflects the equivalent risk on future borrowings by Alpha

On 1 Jan 20x1, the date of the commencement of the lease, Alpha makes the first lease payment, incurs the initial direct costs and receives the lease incentives from the lessor.

Solution: Comprehensive Example (IASB)

Dr/Cr	Description	Dr	Cr
	Initial recognition		
Dr	Right to use asset	405 391	
Cr	Bank		50 000
Cr	Lease liability *		355 391
Dr	Right of use asset (25 000 – 5 000)	20 000	
Cr	Bank		20 000

* FV=0, i= 5%, n=9, PMT= 50 000

IFRS16 IE3 Part 1 Adapted

Solution: Comprehensive Example (IASB)

Dr/Cr	Description	Dr	Cr
	Initial recognition		
Dr	Interest expense (355 391 x 5% x 12/12)	17 770	
Cr	Liability		17 770
Dr	Depreciation (405 391 + 20 0000)/10	42 539	
Cr	Right of use asset		42 539

Amortisation table

- The amortization schedule only shows the first 6 years of the agreement.

Lease Liability				
Year	Beginning balance	Lease payment	Interest expense	Ending Balance
20x1	355 391	-	17 770	373 161
20x2	373 161	(50 000)	16 158	339 319
20x3	339 319	(50 000)	14 466	303 785
20x4	303 785	(50 000)	12 689	266 474
20x5	266 474	(50 000)	10 823	227 297
20x6	227 297	(50 000)	8 865	186 162

Comprehensive Example (Reassessment)

Assume the same illustrative example, except that on 31 Dec 20x6, (after 6 years of the original lease had elapsed), Alpha changed the conclusion that it is **reasonably certain** to exercise the option to extend its original 10-year lease for a **further period of five years** to a total lease term of 15 years. The annual lease payments R55 000 and payable yearly in advance on 1 January for the additional 5 years.

Alpha's incremental borrowing rate at the end year 6 is 6% per annum which reflects the equivalent risk on future borrowings by Alpha. Alpha expects to consume the right-of-use asset's future economic benefits evenly over the lease term

Required:

Prepare journal entries to reflect all matters relating to the lease in the accounting records of Alpha for the year ended **31 December 20x7**.

Amortisation table

Lease Liability				
Year	Beginning balance	Lease payment	Interest expense	Ending Balance
20x1	355 391	-	17 770	373 161
20x2	373 161	(50 000)	16 158	339 319
20x3	339 319	(50 000)	14 466	303 785
20x4	303 785	(50 000)	12 689	266 474
20x5	266 474	(50 000)	10 823	227 297
20x6	227 297	(50 000)	8 865	**186 162**
			Increase	192 012
				378 174
20x7	378 174	(50 000)	19 690	347 864

New PV → Cf0-3= 50 000 , Cf4-8= 55 000 , i= 6%

IFRS16 IE3 Part 2 Adapted

Illustrative example 2 - solution

Dr/Cr	Description	Dr	Cr
	Initial recognition		
Dr	Right to use asset	192 012	
Cr	Lease liability (192 012 – 50 000)		142 012
Cr	Bank		50 000
Dr	Interest expense	19 690	
Cr	Lease liability		19 690
Dr	Depreciation (170 156 + 192 012)/9	40 240	
Cr	Acc Depreciation: RoU		40 240

Amortisation table

- The amortization schedule only shows the first 6 years of the agreement.

Lease Liability				
Year	Beginning balance	Lease payment	Interest expense	Ending Balance
20x1	355 391	-	17 770	373 161
20x2	373 161	(50 000)	16 158	339 319
20x3	339 319	(50 000)	14 466	303 785
20x4	303 785	(50 000)	12 689	266 474
20x5	266 474	(50 000)	10 823	227 297
20x6	227 297	(50 000)	8 865	186 162

THANK YOU!