ICAEW KNOW-HOW

FINANCIAL REPORTING FACULTY

Contract modifications under IFRS

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This webinar will commence shortly ……

Introduction

Sally Baker
Technical manager
ICAEW

Today's presenters

Phil Barden
Partner
Deloitte

Sam Roberts
Senior Manager
KPMG

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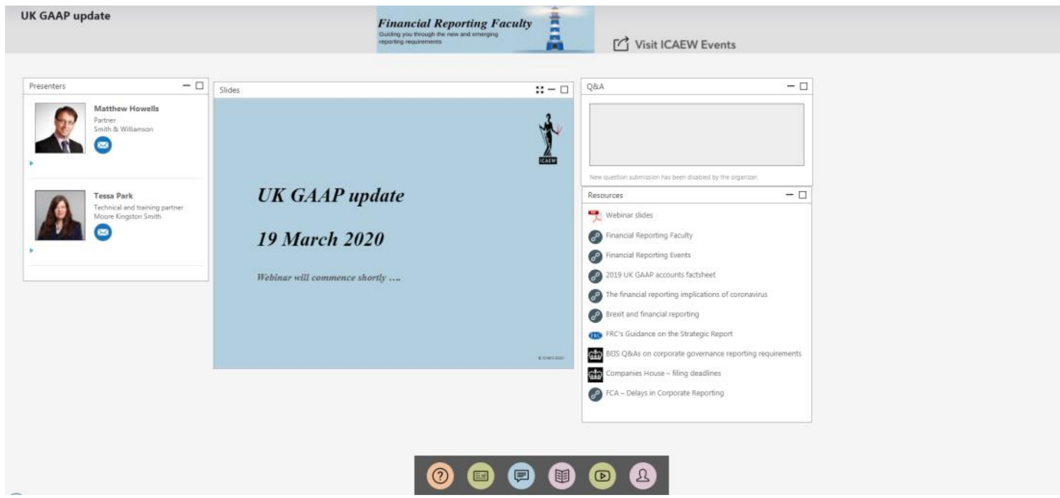

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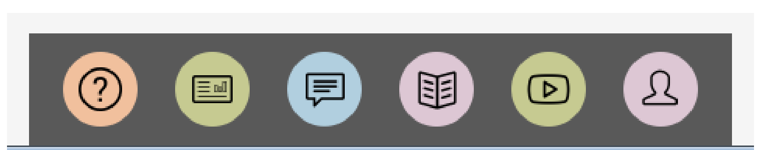

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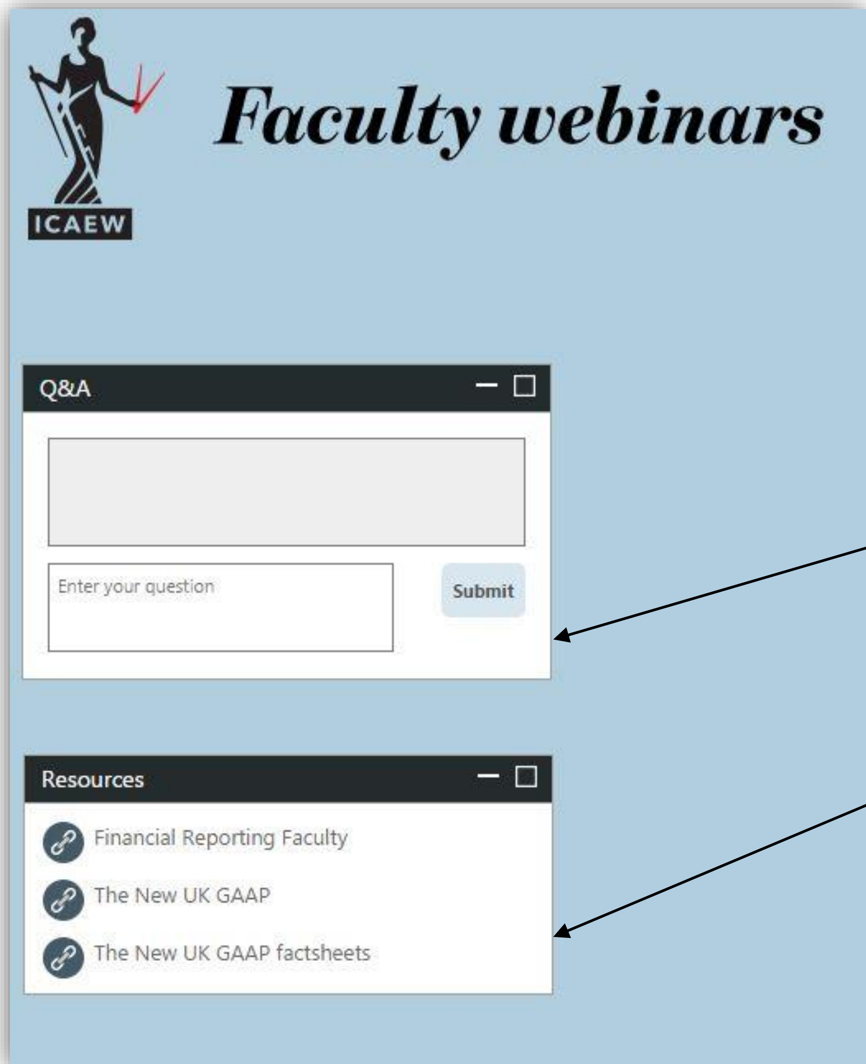

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Contents – Accounting for modifications

Poll question 1

Has the pandemic resulted in increased uncertainties affecting your business's, or those of your clients, revenue recognition?

- Not really
- Yes, but those uncertainties are now mostly resolved
- Yes, and there continue to be some significant uncertainties

IFRS 15 Revenue from Contracts with Customers

ACCOUNTING FOR CONTRACT MODIFICATIONS

IFRS 15 Revenue from Contracts with Customers
This session is about modifications …

… but there are things to think about even when a contract isn't modified:

- Step 1 – is it still probable that amounts will be collected in full?
  - If using a portfolio approach, do you need to disaggregate portfolios?
  - Have you failed step 1 for some contracts? Consequences?

- Step 3 – have estimates of variable consideration changed?
  - Do you need to change the amount by which you are constraining estimates?
  - Impact of late delivery penalties – need to think about guidance in IFRS 15:85
    - i.e. should they be allocated to individual deliveries or contract as a whole?

IFRS 15 Revenue from Contracts with Customers
This session is about modifications …

- Step 5 – has there been an impact on your measure of progress (especially if using cost)?
  - Which costs should be excluded as attributable to significant inefficiencies?
  - Have future necessary costs increased?

- Step 5 – have point in time deliveries been delayed?
  - If so, prima facie, revenue recognition will also be delayed
  - But watch out for bill and hold scenarios
  - Don’t capitalise costs attributable to significant inefficiencies

- Disclosures
  - What additional explanations may be needed in your financial statements?

IFRS 15 Revenue from Contracts with Customers
You think you have a modification …

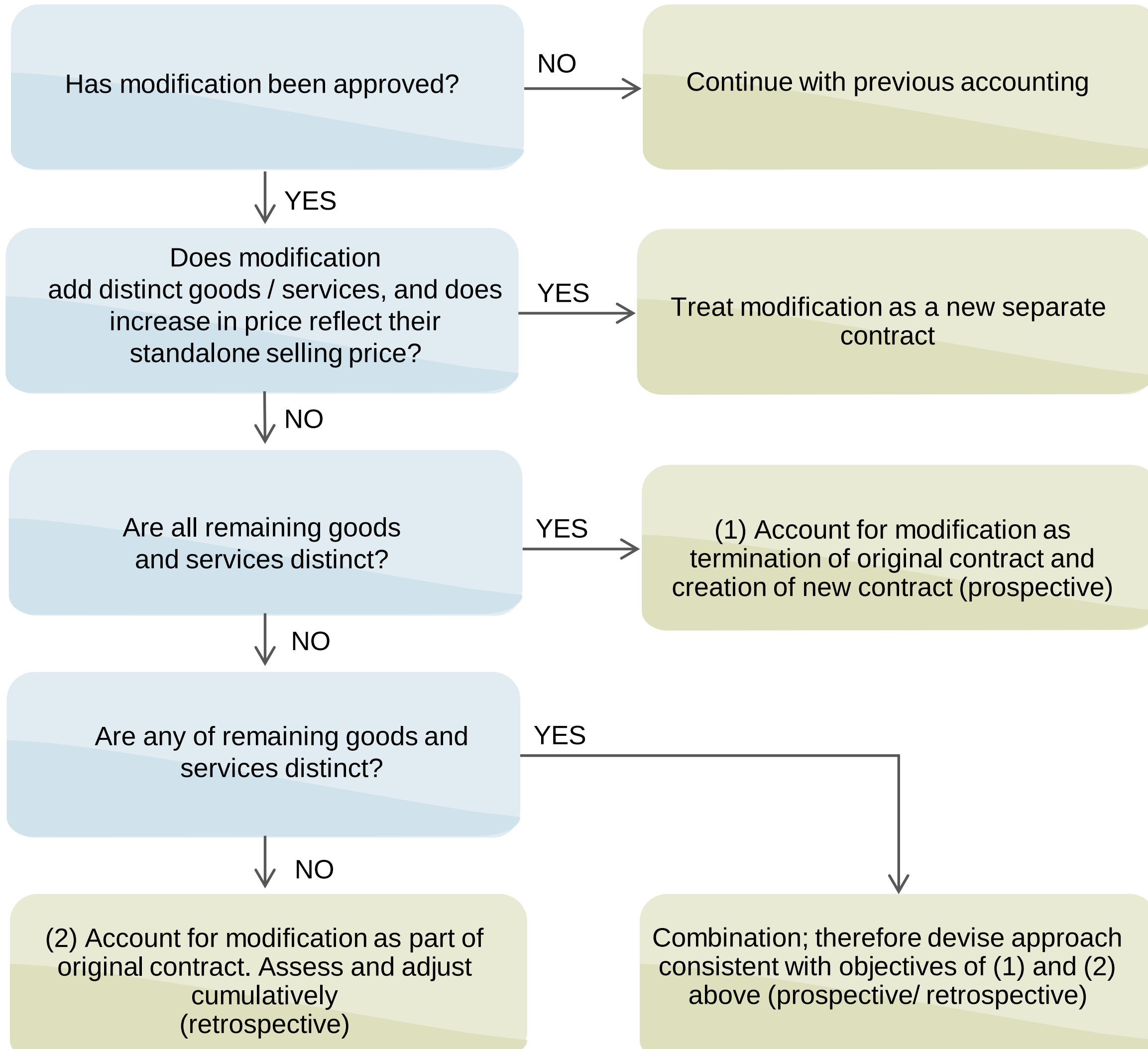
… but do you really?

- A customer is granted a price concession:
  - Is this a contract in which a price concession was always considered to be possible?
  - Or is this an unexpected change that has been specifically negotiated, eg as a consequence of the pandemic?
  - Was it provided in response to a claim by the customer under the contract?

- Customers are provided with additional goods / services for free
  - Was this negotiated with the customer or was it a voluntary action of the seller, not agreed with the customer in advance?
  - Has an obligation been created to supply further goods / services for free in the future?

IFRS 15 Revenue from Contracts with Customers

How does IFRS 15 approach modifications?



IFRS 15 Revenue from Contracts with Customers
How does IFRS 15 approach modifications?

- Quite a prescriptive approach

- Watch out for interaction with the series guidance IFRS 15:22(b) – future goods and services may well be distinct even though the modification occurs part way through the performance obligation

- Even where modification is prospective, an adjustment may be needed to pre-modification revenues if goods / services were not provided in accordance with the contractual terms – see illustration in Example 5 Case B accompanying IFRS 15

IFRS 15 Revenue from Contracts with Customers
Seller grants extended payment terms

- Consider whether collectability threshold is still met? (Step 1)
- Consider whether contract now includes a significant financing component?

IFRS 15 Revenue from Contracts with Customers
Disclosures

- FRC has been sending strong messages on disclosure

- In general, not all IFRS 15 disclosures have previously been as complete and clear as expected

- This year, even greater need to tell a clear story and explain associated uncertainties

IFRS 15 Revenue from Contracts with Customers
Specific disclosures that might need to be enhanced

- Revenue recognised in current period in relation to performance obligations satisfied in previous periods
  - Typically, this is the effect of releasing constrained revenue
  - This year, the amount may be negative for some entities
- Changes to typical timing of payment / payment terms, and impact on contract assets and liabilities
- Explanation of significant changes to contract assets and liabilities, including quantitative information on key impacts
- Significant judgements, and changes in judgements, relating to:
  - Assessing when control is transferred to customer
  - Estimating variable consideration
  - Constraining estimates of variable consideration
  - Measuring obligations for returns, refunds and similar obligations

IFRS 16 Leases

ACCOUNTING FOR LEASE MODIFICATIONS

IFRS 16 Leases
Lessee accounting – new exemption

- Practical expedient allowing specific departure from IFRS 16 rules for lessees
- Only applies where:
  - Rent concession arises due to COVID-19
  - Overall consideration is substantially the same or less
  - Any reductions are only to payments due on or before 30 June 2021
  - No substantive change to other terms / conditions
- Revised (lower) future payments are discounted at original rate
- Credit taken to P&L as reduction in lease expense (to be disclosed)

- When does credit hit P&L?

IFRS 16 Leases
Lessee accounting – other modifications

Assuming neither full nor partial termination of lease:

- Determine new discount rate
- Remeasure lease liability by discounting revised lease payments at new rate
- Adjust carrying amount of right of use asset by change in lease liability

- Thereafter, interest expense is based on new rate

IFRS 16 Leases
Lessor accounting

- No special exemptions granted for lessors
- Modification to an operating lease
  - Treat as a new lease from the effective date of the modification
  - Include any prepaid or accrued lease payments as part of the payments for the new lease
- Watch out for expected credit losses under IFRS 9
  - Applies to operating lease receivables
  - Also reasonable to apply to accrued operating lease income, including lease incentives
- If investment property, watch out for interaction with IAS 40 accounting

IFRS 9 Financial Instruments

ACCOUNTING FOR CONTRACT MODIFICATIONS

Modification of financial liabilities

Key messages

- Under IFRS 9, non-substantial modifications of liabilities result in an immediate gain or loss in the P&L
- We expect a significant increase in the number of modifications due to COVID-19

Agenda

- Amortised cost principles
- Modification rules
- Example

Amortised cost principles

The effective interest rate (EIR)

- The rate that exactly discounts the expected future contractual cash flows to equal the carrying amount
- This can be seen as the rate implicit in the cash flows or the Internal Rate of Return (IRR)
- The EIR is set at the outset and can only be changed in limited circumstances

Amortised cost carrying value

- Equals the expected future contractual cash flows discounted at the EIR

Modification process

Stage 1 – is it a modification?

- Yes – contractual terms renegotiated / modified
- No – Repayment in line with original terms

Stage 2 – substantial modification tests

- **Quantitative test** – substantial if the PV of the cash flows (including modification fees) are at least 10% different under the new terms
- Both old and new cash flows discounted at original EIR
- **Qualitative test** – If not substantial per the above, qualitative factors indicating the terms are substantially different can also be considered

Stage 3 – Accounting

Substantial modifications of liabilities - Accounting

Tests	**Substantial per quantitative / qualitative test** • Difference in NPVs > 10% (B3.3.6)* • Or there are qualitative factors suggesting substantial that are not captured by 10% test
Accounting treatment	**De-recognition** • Carrying value of old liability de-recognised • New liability recognised at FV • Gain or loss in P&L
Costs and fees incurred	**P&L immediately** IFRS 9.B3.3.6

*PV of new CFs (including fees) at original EIR at least 10% different = substantial

Non-substantial modifications of liabilities-Accounting

Tests	**Non-substantial per tests** • Difference in NPVs < 10% (B3.3.6)* • And no qualitative factors suggesting substantial that are not captured by 10% test
Accounting treatment	**Immediate gain or loss in P&L** • New carrying value (excluding fees) is PV of modified cash flows discounted at original EIR • Difference is taken as immediate gain or loss in P&L (B5.4.6)
Costs and fees incurred	**Adjust carrying amount and increase EIR** IFRS 9.B3.3.6

*Scope to revise EIR (B5.4.5) and not recognise an immediate gain or loss is very limited

Loan modification example

- Party Party ltd (PP) is a hospitality company with a 30 June year end. On 30 June 2019 they take out a 5 year interest only loan for £1m at 5% interest payable annually and the £1m repayable in a final bullet payment at the end of 5 years.
- PP pays £100k of arrangement fees upfront on 30 June 2019.
- How should they have accounted for this?

Solution – initial amortised cost accounting

- Record the net proceeds of £900k and calculate the IRR

Y/E 2019	2020	2021	2022	2023	2024
£900k	£(50k)	£(50k)	£(50k)	£(50k)	£(1,050k)

- IRR or EIR = 7.47%

Y/E	B/fwd	EIR charge	Payment	C/fwd
2020	£900k	£67.2k	£(50k)	£917.2k
2021	£917.2k	£68.5k	£(50k)	£935.7k
2022	£935.7k	£69.9k	£(50k)	£955.6k
2023	£955.6k	£71.4k	£(50k)	£977.0k
2024	£977.0k	£73.0k	£(1,050k)	-

Loan modification example - continued

- PP is significantly impacted by COVID during the year ended 30 June 2020. As a result they agree a modification of their loan contract on 30 June 2020, with the bank (where the bank gives them a payment holiday from 1 July 2020 to 30 June 2021). This is not a payment deferral, the interest payment due 30 June 2021 is waived. Assume there are no modification fees payable to the bank but PP pays £10k to external advisers for assisting them with the terms of the modification.
- How do we determine whether this is a substantial or non-substantial modification?

Applying the quantitative test

- Poll: Per the quantitative test, is the modification substantial or non-substantial?

	PV @ original EIR 7.47%	Now 30/6/20 (fees)	2021	2022	2023	2024
Old	£(917.2k)	-	£(50k)	£(50k)	£(50k)	£(1,050k)
New	£(870.7k)	-	-	£(50k)	£(50k)	£(1,050k)

- The table above shows the present value of the original and modified cash flows (including modification fees).
- The adviser fees are not considered modification fees

Poll question 2

Applying the quantitative test, is the modification substantial or non-substantial?

a) Substantial

b) Non-substantial

Solution – quantitative and qualitative tests

	PV @ original EIR 7.47%	Now 30/6/20 (fees)	2021	2022	2023	2024
Old	£(917.2k)	-	£(50k)	£(50k)	£(50k)	£(1,050k)
New	£(870.7k)	-	-	£(50k)	£(50k)	£(1,050k)

- Difference in NPV of cash flows £46.5k
- 5.07% different
- Assume there are no qualitative factors that suggest it is substantial
- Therefore – Non-substantial
- What would the accounting entries be?

Solution – Non substantial modification calculating modification gain / loss

	PV @ original EIR 7.47%	2021	2022	2023	2024
Old	£(917.2k)	£(50k)	£(50k)	£(50k)	£(1,050k)
New	£(870.7k)	-	£(50k)	£(50k)	£(1,050k)

- Difference in NPV of cash flows (excluding costs and fees incurred) discounted at original EIR is £46.5k
- Note - Interest has already been charged for 2020

Recognise immediate gain / loss in P&L in 2020

Dr Loan liability £46.5k

Cr P&L £46.5k

Solution – Non substantial modification accounting for costs fees

- Adjust the new carrying value by deducting the costs and fees incurred(£870.7k – £10k) and recalculate the IRR

Y/E 2020	2021	2022	2023	2024
£860.7k	-	£(50k)	£(50k)	£(1,050k)

- IRR or EIR = 7.79%

Recognise interest at adjusted EIR of 7.79% in 2021

Dr P&L £67k (£860.7k × 7.79%)

Cr Loan liability £67k

Non-substantial loan modifications – key points to check

Question where there isn't an immediate gain or loss recognised at the point of modification

Check underlying amortised cost accounting (especially in relation to fees)

Check the logic: less cash paid or later payments = immediate gain

IAS 19 Employee Benefits and IFRS 2 Share-based Payment

Employee benefits and share-based payments

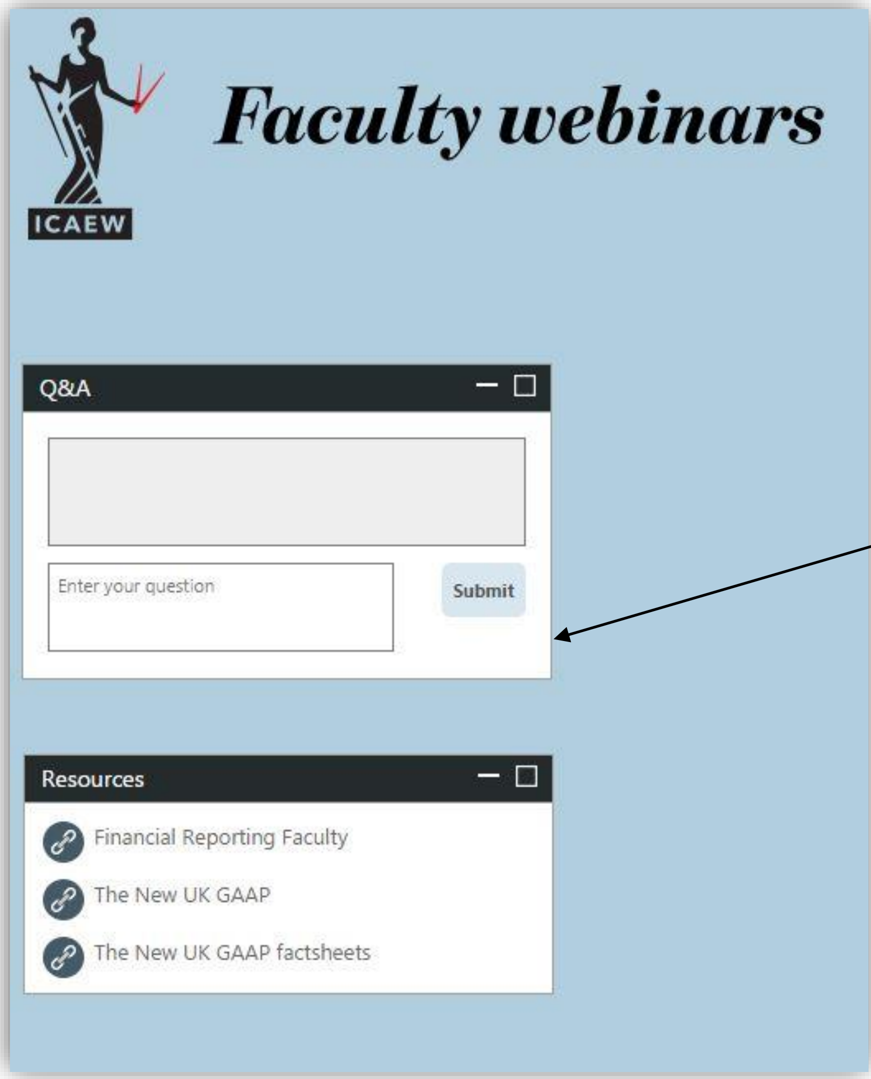
Employee benefits

- Most bonus / incentive schemes are discretionary, so scope for modifications is limited
- Changes to estimates would go to P&L as they arise

Equity settled share based payments

- Modifications only accounted for if beneficial to employee / counterparty
- Most common example: reduction in exercise price
- Recognise incremental FV (measured at modification date) over remaining modified vesting period

Ask a question



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Faculty resources
icaew.com/financialreporting

- Accounting standards webpages

  icaew.com/ifrs15

  icaew.com/ifrs9

- Factsheets icaew.com/frffactsheets
  - IFRS 9 Financial Instruments - overview
  - Revenue from Contracts with Customers
  - IFRS 16 Leases
- COVID-19 and financial reporting

  icaew.com/coronavirus/financial-reporting

- Webinar recordings icaew.com/frfwebinars
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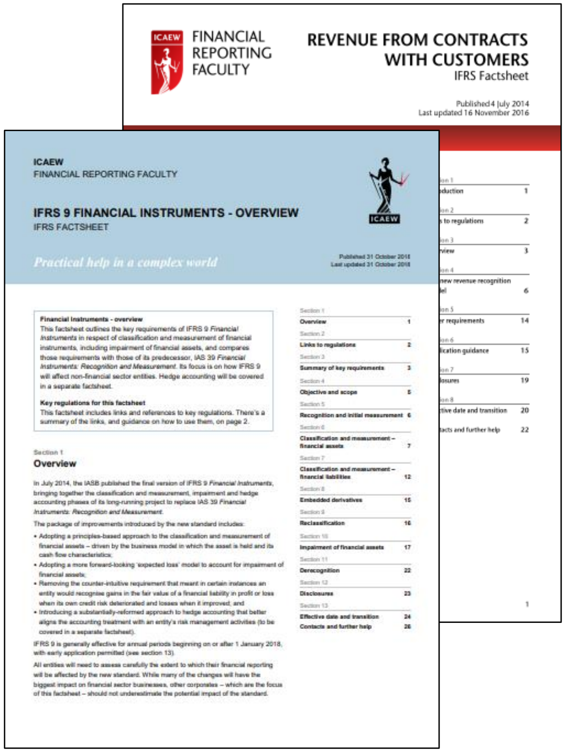

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2020 Members' event – recordings available

Going concern and resilience: lessons learned from COVID-19 icaew.com/goingconcernevent

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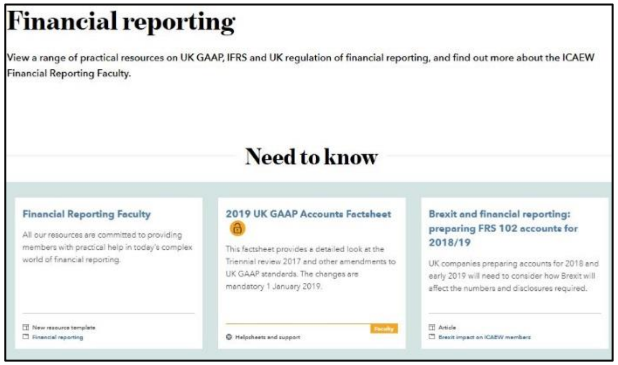

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Questions

Phil Barden
Partner
Deloitte

Sam Roberts
Senior Manager
KPMG

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Contact the Financial Reporting Faculty

Phone: +44 (0)20 7920 8533

Email: frfac@icaew.com

Web: icaew.com/frf

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