A Corporate Treasury Focus on COVID-19 Accounting Considerations

Release Date: 28 May 2020

COVID-19: Top Accounting Issues for Corporate Treasurers

At a glance

The coronavirus (COVID-19) pandemic has had, and will continue to have, far-reaching implications. In many parts of the world, governments have brought in never-before-seen measures, including mass quarantines, social distancing, border closures, shut-downs of non-essential services, and considerable (in some cases, unlimited) commitments to provide financial support to affected businesses and individuals. Just as the medical implications are emerging and evolving rapidly, so too are those related to the economic and credit environment.

COVID-19 will impact many areas of accounting and reporting for all industries, as outlined in our publication In depth: Accounting Implications of the Effects of Coronavirus. Corporate treasurers are already in the spotlight, given their central role in managing liquidity in this challenging time. In this Spotlight we focus on the accounting implications that treasurers in corporate entities (that is, non-financial institutions) might also face. This Spotlight covers:

- hedge accounting;
- factoring and reverse factoring/supplier finance;
- fair value of financial assets and liabilities;
- ‘own use’ and onerous contracts;
- intercompany loans and trade receivables – expected credit losses; and
- other considerations.

While this Spotlight focuses on the areas listed above, there will be other related accounting issues. Entities are reminded to consider all potential accounting issues. Further guidance on these and other issues is given in the In depth referred to above, which is updated regularly as new issues arise.

To discuss any issues further, please speak to your local PwC treasury contact.

1. Hedge accounting

1.1 Cash flow hedges – highly probably requirement

Management should consider the impact of COVID-19 on its existing hedges, in particular whether the hedges continue to meet the criteria for hedge accounting. Both IFRS 9 and IAS 39 only allow a forecast transaction to be designated as a hedged item in cash flow hedge if that transaction is highly probable. In many cases, COVID-19 has significantly impacted the timing and amount of both operating and financing cash flows. In such circumstances, corporate treasurers will need to reassess their cash flow hedges and, in particular, whether a hedged forecast transaction is still *highly probable* to occur.

For similar reasons, management should also consider the impact of COVID-19 on its ability to designate new hedges, because future cash flows might be less predictable than has historically been the case.

In assessing the likelihood that a transaction will occur in light of COVID-19, there is a range of factors that might be relevant, depending on the particular facts and circumstances. These include, but are not limited to, the following:

- the financial and operational ability of the entity to carry out the transaction (for example, retailers that have closed stores, or airlines that have curtailed operations);
- the entity's revised business plans as a result of COVID-19;
- the likelihood of disruptions to a particular activity (for example, a manufacturing facility that might need to be repurposed or shut down); and
- the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, changing delivery methods for goods or services).

The accounting treatment will depend on the conclusion on the probability of the forecast transaction occurring:

- If management no longer expects the forecast transaction to occur, the hedging relationship is discontinued and the amount deferred in the cash flow hedge reserve is reclassified to profit or loss. After discontinuing the hedging relationship, the hedging instrument will subsequently be measured at fair value through profit or loss, unless it is designated in a new hedging relationship.

- If the forecast transaction is delayed as a consequence of COVID-19, the accounting treatment will depend on both how precisely the hedged item was defined and whether the effectiveness criteria for hedge accounting continue to be met.

  If the effectiveness criteria are no longer met or the forecast transaction is no longer highly probable but is still expected to occur, the hedging relationship is discontinued, but the amount deferred in the cash flow hedge reserve is retained in equity and will be recognised in profit or loss along with the hedged item. After discontinuing the hedging relationship, subsequent changes in the fair value of the hedging instrument will be recognised in profit or loss, unless the instrument is designated in a new hedging relationship.

  If the effectiveness criteria continue to be met and the forecast transaction is still highly probable, management will assess the ineffectiveness caused by the delayed forecast transaction. Where the cumulative change in the hedging instrument exceeds the change in the hedged item (sometimes referred to as an 'over-hedge'), ineffectiveness will be recognised in profit or loss for the excess. If the cumulative change in the hedging instrument is less than the change in the hedged item (sometimes referred to as an 'under-hedge'), no ineffectiveness will be recognised.

- For entities reporting under IFRS 9, further guidance is given in:
  FAQ 3.3.2 – What factors should be considered in assessing the 'highly probable' criterion for cash flow hedges of forecast purchases or sales in light of disruptions to the supply chain or sales process as a result of COVID-19 (IFRS 9)?

For entities reporting under IAS 39, further guidance is given in:
FAQ 3.4.2 – What factors should be considered in assessing the ‘highly probable’ criterion for cash flow hedges of forecast purchases or sales in light of disruptions to the supply chain or sales process as a result of COVID-19 (IAS 39)?

1.2 Other hedge accounting issues

A number of other hedge accounting issues could arise. In depth INT2020-02 is updated on a regular basis for new issues identified. Examples include:

- Implications of floors in variable-rate loans designated in cash flow hedges. If a floor is triggered, the criteria for hedge accounting might no longer be met or ineffectiveness might arise.

  For entities reporting under IFRS 9, further guidance is given in:
  FAQ 3.3.1 – How do floors in variable-rate loans affect the application of cash flow hedge accounting (IFRS 9)?

  For entities reporting under IAS 39, further guidance is given in:
  FAQ 3.4.1 – How do floors in variable-rate loans affect the application of cash flow hedge accounting (IAS 39)?

- Implications of payment holidays. The impact on cash flow hedges might depend on whether payments are cancelled or deferred and how the hedged item was designated. The payment holiday will generally create some ineffectiveness and, in some cases, could result in discontinuation of the original hedging relationship if the hedged item is no longer deemed to exist.

  For entities reporting under IFRS 9, further guidance is given in:
  FAQ 3.3.3 – Hedge accounting and payment holidays

  For entities reporting under IAS 39, further guidance is given in:
  FAQ 3.3.4 – Hedge accounting and payment holidays (IAS 39)

- If the cash flow hedge reserve is in a loss position and an entity expects that all or a portion of the loss will not be recovered in future periods, IFRS 9 (and IAS 39) require the amount that is not expected to be recovered to be immediately reclassified to profit or loss. Entities should therefore consider whether they are able to substantiate the recoverability of loss positions in the cash flow hedge reserve.

2. Factoring and reverse factoring/supplier finance

Following the increased uncertainty caused by COVID-19, corporates are looking at many ways to improve liquidity – that is, the availability of short-term cash in all its forms. Corporate treasurers might look again at methods of speeding up the cash conversion cycle – for example, by selling their trade receivables to a factoring company (‘factoring’) – or make changes to supplier finance arrangements.

Factoring

Entities selling trade receivables should assess whether the factoring arrangement results in the trade receivables being derecognised. Entities need to consider whether the derecognition criteria are met each time a receivable is sold – that is, the analysis of a factoring or similar programme is not static, and it needs to be reassessed each time a new sale occurs. As a result of COVID-19, certain exposures to risks and rewards and the relative size of each kind of risk might have changed, which will need to be incorporated into the assessment.

Furthermore, entities that enter into factoring arrangements more frequently, as a consequence of COVID-19, will need to evaluate the impact on the business model of accounts receivables. Depending on the number of accounts receivable (expected to be) sold and derecognised following factoring, the business model for accounts receivable could be any of: hold to collect (measurement at amortised cost); hold to collect and sell (measurement at fair value through other comprehensive income, with profit or loss recycling); or ‘other’/hold to sell (measurement at fair value through profit or loss).

Further guidance is given in FAQ 3.1.1 – How will factoring or other sales of trade receivables be impacted by COVID-19?

Reverse factoring/supplier finance

As a result of the economic circumstances triggered by COVID-19, an entity might enter into a new supplier finance arrangement or make changes to existing arrangements, such as adding a guarantee from a parent (or other group company) or extending payment dates. For those balances subject to the new terms, the entity should reassess whether the original trade payables are extinguished, as well as the appropriate presentation of the payables based on the updated terms. Appropriate disclosures should also be provided (for example, the changes to the terms and, where the conclusion is considered to be a critical accounting judgement, the disclosures required by para 122 of IAS 1).
Even if the original trade payable or receivable is not derecognised, some regulators expect an entity to disclose in its financial statements that it has entered into trade financing arrangements. For a more detailed view on the required disclosures, see FAQ 3.5.1 – How is the accounting for supplier finance arrangements impacted by COVID-19?

3. Fair value of financial assets and liabilities

Treasurers often have investments in financial instruments that are held as part of managing their cash position or to invest for the longer term, as well as derivatives that are held for risk management purposes. The measurement of fair value of an investment in financial instruments is governed by IFRS 13. Where fair value is based on a quoted price in an active market, the quoted price at the reporting date should be used. Changes in market prices after the reporting date are not reflected in asset valuation.

The volatility of prices on various markets has increased as a result of the spread of COVID-19. This affects the fair value measurement either directly – if fair value is determined based on market prices (for example, in the case of shares or debt securities traded on an active market) – or indirectly (for example, if a valuation technique is based on inputs that are derived from volatile markets).

Credit risk and the credit spread that is used to determine fair value might also increase. For corporate treasurers, this is particularly relevant for any Over-The-Counter (OTC) derivatives held, where both the credit risk of the counterparty (CVA) and the entity's own credit risk (DVA) will be reflected in the fair value. While the impact of actions taken by governments to stimulate the economy might reduce risk-free interest rates, which could compensate for this change in credit risk, it is worth noting that CVA/DVA should not be included in hypothetical derivatives that are often used to measure ineffectiveness in a cash flow hedge and that can represent a source of ineffectiveness.

IFRS 13 requires entities to disclose the valuation techniques and the inputs used in the fair value measurement, as well as the sensitivity of the valuation to changes in assumptions. COVID-19 might also affect the sensitivity analysis required for recurring fair value measurements categorised within Level 3 of the fair value hierarchy, because the number of instruments classified as Level 3 might increase.

See the following FAQs for further guidance on this topic:
FAQ 3.8.1 – Determining whether a market is still active in a period of market disruption
FAQ 3.8.2 – Assessing prices in inactive markets
FAQ 3.8.3 – Determining whether transactions are orderly
FAQ 3.8.4 – Adjustments to the quoted price in an active market
FAQ 3.8.5 – Delays in the availability of information
FAQ 3.8.6 – Post market closure events
FAQ 3.8.7 – Uncertainties in cash flow fair value measurement of financial instruments
FAQ 3.8.8 – Should possible future modifications be considered when determining the fair value of a debt instrument?
FAQ 3.8.9 – Consideration of fair value where an entity has breached a debt covenant

4. 'Own use' and onerous contracts

Contracts to buy or sell a non-financial item that can be settled net in cash are within the scope of IFRS 9 (with the result that they are typically accounted for as derivatives), unless the contracts were entered into and continue to be held for the purpose of receipt or delivery of non-financial items to meet the entity's expected purchase, sale or usage requirements ('own use').

COVID-19 might impact whether some contracts meet these 'own use' requirements. For example, disruption to an entity's supply chain due to COVID-19 might have the effect that certain commodity contracts will be settled net in cash rather than by physical delivery.

However, to the extent that such contracts continue to fall outside the scope of IFRS 9, they would need to be evaluated to determine whether they are onerous contracts within the scope of IAS 37.

These considerations can be complex, and we encourage entities to discuss these matters with their professional advisors.

5. Intercompany loans and trade receivables – expected credit losses

IFRS 9 requires entities to incorporate forward-looking information into the calculation of expected credit losses (ECLs). This requires consideration of credit risk, so many treasurers now support the finance function in developing the methodology and assessing the adequacy of the ECLs. ECLs are a key area of focus in the current environment, due to a perceived increase in the credit risk of customers.

Key messages in the IASB document

In March 2020 the IASB issued a short document on the application of IFRS 9 in the light of uncertainty arising from the COVID-19 pandemic. The IASB document is intended to support the consistent and robust application of IFRS 9. It acknowledges that estimating ECL is challenging in the current circumstances and that *"it is likely to be difficult at this time to incorporate the specific effects of COVID-19 and government support measures on a reasonable and supportable basis"*. However, the IASB is also clear that *"changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weightings"*.

Key messages for all entities, including corporate treasury functions, include:

- all reasonable and supportable information available should be used – historical, current and forward-looking where possible; and
- IFRS 9 does not prescribe any bright lines or a mechanistic approach.

We consider below the implications of this and other guidance for corporate entities.

ECLs to be evaluated following COVID-19

In light of COVID-19, all financial receivables should be assessed for a potential increase in ECL. For corporate treasurers, the main balances affected are likely to be intercompany loans and trade receivables. Entities should focus, in particular, on the following areas:

- A simplified approach of using lifetime ECL – for example, using a provision matrix is still available for trade receivables and contract assets that do not contain a significant financing component, but forward-looking information must be considered in assessing credit risk and in measuring ECL. The extent to which delays are due to credit risk or merely an indication of operational issues will need to be carefully considered.

- For loan receivables (intercompany outside financial institutions), entities will need to assess whether a significant increase in credit risk (SICR) has occurred in relation to these loans. In doing so, entities will need to distinguish between those subsidiaries that are significantly affected and those that are less affected. When, prior to the start of COVID-19, a loan was in Stage 1, an SICR would mean that a lifetime, rather than 12-month, ECL was required.

  Although it is important to assess staging (i.e. Stage 1 versus Stage 2 or 3) as part of the overall ECL assessment, we note that staging might have a smaller impact on the overall ECL than other judgements and estimates. This is because, even if the loan remains in Stage 1, COVID-19-related defaults or events that could cause a future default might be expected to take place quickly, and therefore be captured in the 12-month ECL.

- Given the speed with which events are unfolding, measuring ECLs for March and June 2020 year ends or interim reports is likely to be particularly challenging. Entities will need to develop an estimate based on the best available data about past events, current conditions and forecasts of future economic conditions. Adjustments to expected loss rates in provision matrices and overlays to formal models (where used) will be needed.

- Updated facts and circumstances should continue to be monitored for any new information relevant to assessing the conditions at the reporting date. For example, when measuring ECL at the end of each reporting period, entities will need to consider the likelihood of debtors paying, the value of any existing credit enhancements such as financial guarantees, and the effect of any government initiatives.

For more detailed information on this subject, see:
In the Spotlight: How corporate entities can apply the requirements of IFRS 9 expected credit losses (ECL) during the COVID-19 pandemic

See also the following FAQ for further guidance on this topic:
FAQ 3.2.3 – In the context of COVID-19 and ECL, what information is ‘reasonable and supportable’?

6. Other considerations

In addition to the topics highlighted above, corporate treasurers will need to consider the accounting consequences of COVID-19 on the following topics:

Subject relevant for corporate treasurers	Accounting impact
Cash and cash equivalents	IAS 7 defines cash equivalents as short-term highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. COVID-19 has resulted in the value of some money market and other funds declining more than insignificantly. Furthermore, some money market funds include clauses which allow the fund manager to restrict redemption in unlikely events, one of which might be the emergence of COVID-19. Management should consider whether investments previously classified as cash equivalents continue to meet the definition in light of these declines in value and/or restrictions on redemption. Investments might need to be reclassified out of cash equivalents.
Cash pooling	Treasurers might choose to make more use of cash pooling arrangements (‘zero balancing’ or ‘notional pooling’). With zero balancing (sometimes referred to as a ‘cash sweep’), the cash balances within the arrangement are transferred to a single netting account on a regular basis. This helps treasurers to control the amount of cash in certain locations, and to direct cash to where it is needed. Entities should be aware that, in many cases, zero balancing arrangements should be accounted for as intercompany balances (not cash) by all entities except the treasury entity or principal account holder. Where each entity in a cash pooling arrangement does have its own bank account, the cash and overdraft balances can only be shown net in the group balance sheet if certain conditions are met, including a currently legally enforceable right to offset and an intention to settle period-end balances. Cross-guarantees between entities are also more likely to be called on as a result of COVID-19. Treasurers should revisit the terms of cash pooling arrangements to assess the accounting implications of more regular sweeping and the use of any guarantees.
Current versus non-current classification of debt and derivatives	Entities will need to consider the implications for debt and derivatives of any break clauses or early termination clauses and how they are impacted by COVID-19. Expectations of whether such clauses will be exercised can affect whether debt and derivatives should be classified as either current or non-current.

Subject relevant for corporate treasurers	Accounting impact
Government assistance	Governments around the world have reacted to the impact of COVID-19 with a variety of measures, including tax rebates and holidays and, in some cases, specific support including loans for businesses, in order that those businesses are able to support their customers. Management should consider whether this type of assistance received from a government meets the definition of a government grant in IAS 20, 'Accounting for government grants and disclosure of government assistance'. The guidance in IAS 20 should be applied to a government grant. For more detailed guidance, see FAQ 3.1.6 – How to account for financial support arrangements put in place by central banks in response to COVID-19
Refinancing of loans	Treasurers will want to check the terms of existing facilities and borrowings, and they might want or need to refinance (either by accepting payment holidays or by revisiting their expected debt requirements and availability of credit lines over the next few months or years). The impact of any changes to the terms of a loan agreement, perhaps because of actions taken by local government or the renegotiation of terms with the lender, should be assessed. Borrowers should apply the guidance in IFRS 9 to determine the impact of the change in terms, including those for determining whether the change to the terms results in derecognition and, if not, for recognising a modification gain or loss. See 'Government assistance' above if new or revised borrowings are linked to government initiatives. Note that, for borrowers, disclosure of any gain on modification is required by paragraph 20(a)(v) of IFRS 7.
Leases	A lessor and a lessee might renegotiate the terms of a lease as a result of COVID-19, or a lessor might grant a lessee a concession of some sort in connection with lease payments. In some cases, a lessor might receive compensation from local government as an incentive to offer such concessions. Both lessors and lessees should consider the requirements of IFRS 16, 'Leases', and whether the concession should be accounted for as a lease modification and spread over the remaining period of the lease. Lessors and lessees should also consider whether incentives received from local government are government grants. The IASB recently approved a practical expedient, that a lessee could elect not to assess whether a COVID-19-related rent concession is a lease modification, for payments originally due on or before 30 June 2021. Further guidance on lease accounting in the current environment is available in In depth INT2020-02 FAQs 4.1, 4.2 and 4.6. Finally, the lease liability recognised for any new leases entered into should be calculated using the entity's current incremental borrowing rate (adjusted for the specifics of the lease). Incremental borrowing rates might have changed as risk-free rates have fallen, but credit spreads have likely increased.

Subject relevant for corporate treasurers	Accounting impact
Liquidity risk disclosures	In addition to the IFRS 13 fair value disclosures referred to above, additional disclosures about liquidity risk might be needed where COVID-19 has affected an entity's normal levels of cash inflows from operations or its ability to access cash in other ways, such as from factoring receivables or reverse factoring/supplier finance arrangements.

Conclusion

COVID-19 has given rise to challenges that have affected virtually every aspect of modern life. The economic implications of the virus will have a consequential impact on many aspects of accounting and financial reporting. We hope that this Spotlight will help you and your advisors as you navigate the key issues as they relate to corporate treasurers.

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