

Accounting implications of government assistance, tax and other fiscal stimulus

April 2020



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Introduction

In response to the COVID-19 pandemic, governments around the world are considering, or have implemented, legislation to cushion and help households and entities that are experiencing financial difficulty arising from the pandemic.

The Federal Government of Nigeria is not an exception as the government has announced a number of measures to address the impact of COVID-19. Notable amongst these measures are the specific pronouncements by the Central Bank of Nigeria (CBN) that include extension of moratorium for government backed facilities, interest rate reduction, forbearance measures and additional credit support for some industries like HealthCare. There have also been fiscal measures taken by the federal government to address the effect of COVID-19 from a national perspective which will see a rise in national debt including local and foreign debt, significant cut in spending at the federal and state levels arising from the reflection of new realities to the federal budget and possible slowing of the economy in the foreseeable future. The essence of this paper is to discuss the accounting implication of the government assistance and its implications in accounting terms for businesses.



Government assistance

Relief programmes that are calculated and distributed to an entity without any link to taxable income falls within the scope of IAS 20. It is important to mention this because government assistance that is provided for an entity in the form of benefits that are available in determining taxable income or are determined or limited on the basis of income tax liability are exempted from IAS 20.

Although IAS 12 which deals with income taxes excludes government grants and investment tax credit from its scope as well. So depending on what type of relief programme, it falls within the scope of IAS 20 or IAS 12. For example, deferral of payment of income tax or temporary changes in the income tax rate applicable to an entity. While there has been no relief relating to investment tax credit from government, when this arises in the near future due to measures to rejuvenate a possible slowing economy it becomes a matter of judgement under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors to determine the most appropriate accounting treatment. It may be appropriate to analogise to IAS 12 or IAS 20. Generally, if an approach similar to IAS 12 is adopted, a credit will be recognised in profit or loss as part of income tax expense/income, and the related asset in the statement of financial position, when the entity satisfies the criteria to receive the credit (and the government measure is substantively enacted). If the substance of the arrangement is considered to be closer to a government grant, and an IAS 20 approach is adopted, the credit will be recognised in profit or loss over the periods necessary to match the benefit of the credit with the costs for which it is intended to compensate.

The more practical and effective ones are the actions of CBN such as lowering interest rates for some type of loans,

payment extension, moratorium extension and in some cases possible forgiveness of loans. A forgivable loan from government, for which the government has undertaken to waive repayment due to the direct or indirect impact of COVID-19 is treated as a government grant in the books of the receiving entity since there is reasonable assurance that the entity will meet the terms for forgiveness of the loan. The benefit of a government loan that has witnessed a cut in interest rate further increasing the below-market- rate gap is also treated as a government grant. The loan is recognised and measured in accordance with IFRS 9. The benefit of the below market rate of interest is measured as the difference between the initial carrying amount of the loan determined in accordance with IFRS 9 and the proceeds received. This benefit is accounted for in accordance with the general principles of IAS 20. The entity is required to consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

A grant related to income such reimbursement of certain expenditure is recognised as part of profit or loss either, as an accounting policy choice:

1. Separately or under a general heading such as 'other income'; or
2. As a deduction in reporting the related expense. A grant related to the

acquisition of an asset is recognised in the statement of financial position either, as an accounting policy choice:

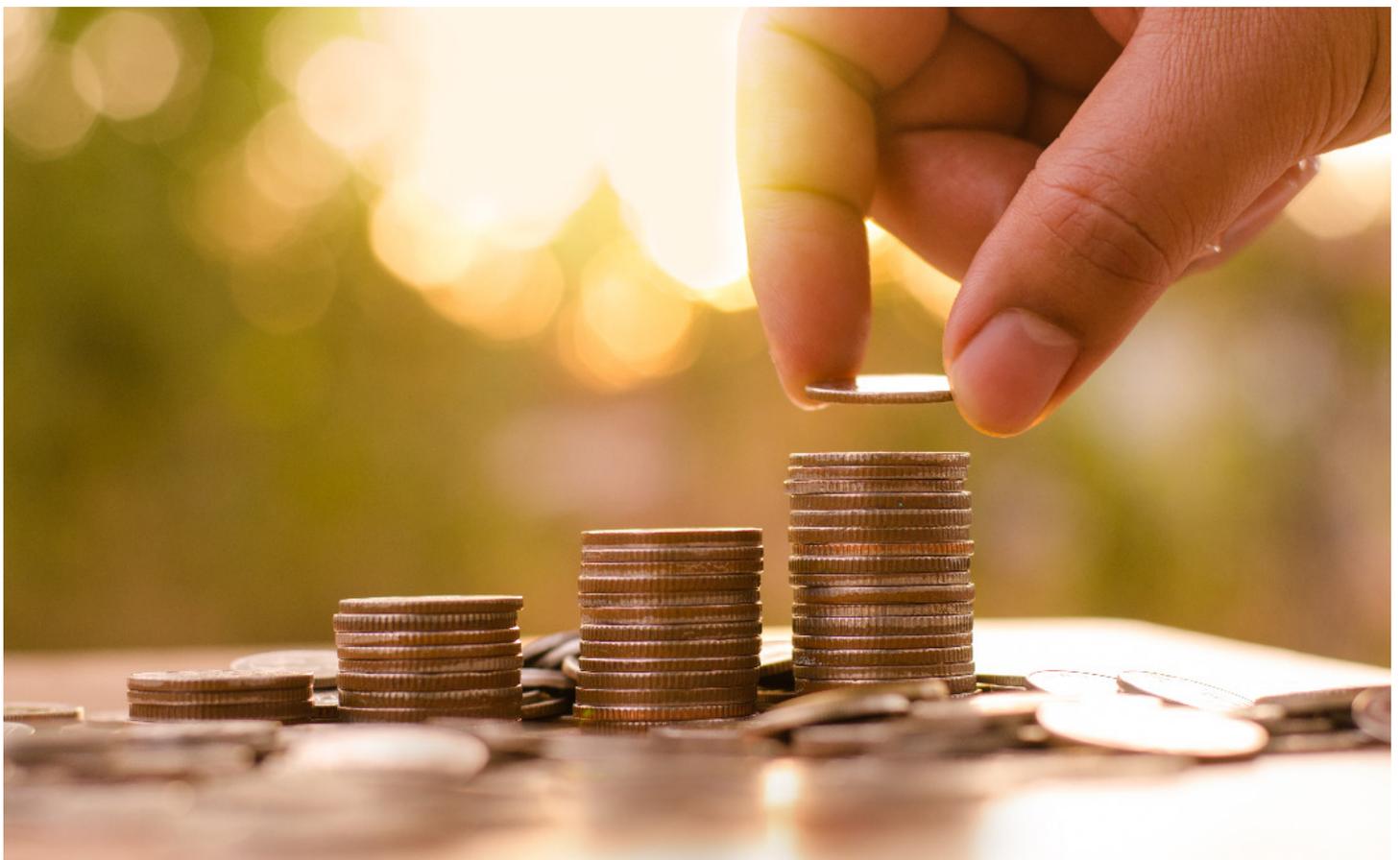
1. Recognising the grant as deferred income, which is recognised in profit or loss on a systematic basis over the useful life of the asset; or
2. Deducting the grant in calculating the carrying amount of the asset, in which case the grant is recognised in profit or loss over the life of a depreciable asset by way of a reduced depreciation expense.

If the tax authorities decide to give some relaxation measures, then tax relief and credits determined to be in the scope of IAS 12 should be reflected in the recognition and measurement of tax amounts only when the tax measure is substantively enacted. The assessment of whether a measure is substantively enacted depends on the relevant local legislative process. When an entity is uncertain of whether it will meet the conditions to be eligible for a substantively enacted tax measure, it should apply the requirements of IFRIC 23 Uncertainty over Income Tax Treatments. If an entity concludes that it is not probable that a taxation authority will accept its tax treatment, the entity should reflect the effect of the uncertainty in determining the related tax balances.

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Macroeconomic impact on Financial Instruments

IFRS 9, the standard governing the recognition and measurement of Financial Instruments is purposefully designed to be forward looking, reflecting expectations of future credit events (and resulting cash short falls) assessed at the reporting date.



The determination of the Expected Credit Loss (ECL) should reflect all reasonable and supportable information including that which is forward looking (IFRS 9:5.5.4). Forward looking information comes in a variety of forms, including, but not limited to:



Macro economic forecasts, including GDP, industry sector growth rates, unemployment, inflation, interest rates, foreign exchange rate, government debt, crude oil prices etc.



Borrowers' probability of non payment in response to macro economic factors that specifically relate to the borrower, noting that borrowers may prioritise payments of some debt obligations over others and so the credit risk of amounts owed by the same borrower can vary.



Borrower behaviour in respect of timing of prepayment or extension options or use of undrawn facilities that impact the lender's exposure.



Valuation of collateral and timing of foreclosure.

The incorporation of macroeconomic factors in ECL modelling is a major requirement of IFRS 9 and many entities have developed models to reflect the risk arising from expectation of future macro state on ECL risk parameters such as Probability of Default (PD) and Loss Given Default (LGD). Though the major component of the COVID-19 impact on the economy comes from the lock down and business inactivity which many argue creates an artificial credit event from an ECL perspective, it is however a reality even if its caused by the pandemic. The Federal Government downward revision of the benchmark price used for the 2020 budget from \$57 to \$30 per barrel and the cut in oil production from 2.1mbpd to 1.7mbpd is a strong economic indicator of the challenges ahead. Foreign exchange rate is responding to the impact with the economic devaluation of the Naira and mounting CBN losses on foreign exchange forwards as counterparties gain from weakened naira spot rates for already existing forward transactions. Certainly the combined effect of these policies will snowball into a weaker GDP. The extent to which COVID-19 will fuel GDP growth decline is not known. It may have short term, medium term or even a long term effect especially where there other underlying challenges in the economy. Entities must therefore use forward-looking information that reflects the anticipated short-term nature of the shock if that is where the weight of probability lies. In summary all current realities and expectation of future macro state will need to be modelled.

The guidance is for entities forward looking information to take into consideration multiple scenarios. Banks for example may consider a “V” shaped economic recovery scenario that reflects a rapid recovery of distressed borrowers. However, given the uncertainties of whether such a recovery will occur, the inclusion of other more distressed downside economic scenarios should be considered, such as a “U” shaped economic recovery where the pace of the recovery is slower. Multiple economic

scenarios should incorporate different speeds by which borrowers may resume payments, i.e. the cure rate. The inclusion of multiple economic scenarios is particularly important at times of heightened uncertainty given the non-linearity of how cash shortfalls arise in an economic downturn. The probabilities assigned to these multiple economic scenarios will often be a significant judgement warranting disclosure.

One way of overcoming the challenge of incorporating “all current information” in loss estimation particularly for non-retail portfolios is to use a market implied default risk measure, such as Expected Default Frequency (EDF). By their nature, EDFs will already capture all the relevant information that is available at a specific point in time. For this reason they are attractive at the moment because they will already have all expectations of the negative effect of the pandemic on business cash flow together with the positive impacts of central bank and government related stimulus priced in. Unfortunately we do not have this data in our market, but it can be indicative of what global default rates look like so it can be used as benchmark or control point for setting lower threshold points. The next challenge for some entities is forecasting losses using reliable economic forecasts. A Credit Cycle Index (CCI) can be constructed that can be used to calculate a PD term structure (a forecast of the path of PD over a specified time horizon). A Monte Carlo simulation-based approach can be used to simulate the various paths of CCI over a forecast horizon. When applied within an ECL framework, the result is a loss distribution from which the unbiased expectation can be determined. Whilst many entities in Nigeria have adopted a discrete scenario approach using three to five defined scenarios, a simulation-based approach can also be used to inform ECL estimates. This approach has the advantage that it is very quick to implement and does not require the development of new economic scenarios or associated probability weights. Our view is that a simulation approach is

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therefore a powerful way to triangulate the output of a scenario based ECL estimate, and potentially offer guidance as to the scenario weightings or level of manual overlay that should be applied due to COVID-19. Given all indices, provisions are more likely to spike than reduce or maintain its levels in reaction to the current and possible future economic realities.

CBN Measures

The measures taken by CBN as palliatives for COVID 19 are the following:

-  Extension of moratorium
-  Interest rate reduction
-  Forbearance
-  Payment holidays
-  New government lending facilities



Modification

We have discussed that some of these measures will have an IAS 20 impact from an obligor perspective. For the banks and lending institutions, the accounting effect is completely different. Some of these measures result in a change to the contractual terms of loan assets which need to be assessed to determine how they affect the subsequent accounting for the loan (see below). There may be cases where a lender has expressed an intention to modify the contractual terms of an instrument but has not yet entered into a contractually binding agreement to do so. Such an intention does not affect the accounting for the instrument because it is not contractually binding and therefore does not change the existing contractual terms. However, such intentions may affect the staging of exposure and the measurement of ECL given that ECL is based on expected cash flows (e.g. borrowers may delay their cash payments based on expected revised cash flows before they are contractually in place). Measures that support the borrower to pay the amounts due under the original terms of their loan will impact the measurement of ECL but will not affect the gross carrying amount of the loan. Measures that provide a reimbursement, either part or in full, to the lender to cover losses suffered due to non payment by the borrower that are not integral to the terms of the original loan will not affect the accounting nor the ECL measurement for the loan and are accounted for separately from the loan as they are not deemed part of the loan contract. Where the contractual terms of a loan asset that is measured at amortised cost or FVTOCI are modified, that modification needs to be assessed under IFRS 9 to determine whether it results in derecognition of the asset. For the avoidance of doubt, any change in expected cash flows that is contemplated under a loan asset's existing contractual terms is not considered a modification. For example, if the loan includes an option to delay payment and that option is exercised, this is accounted for under the amortised cost measurement requirements and does not represent a modification of the contractual terms – it represents an application of the contractual terms.



Forbearance

When the terms of a loan are modified in response to the borrower's financial difficulty, this will often represent a concession or forbearance provided to the borrower which if not provided would have resulted in default and a credit shortfall for the lender. If this is the case, the asset meets the definition of credit impaired (i.e. it is in stage 3). However, not all loan modifications, such as payment holidays, will result in a Significant Increase in Credit Risk (SICR) movement to (stage 2 or 3) or in the loan being credit impaired (stage 3). Where modifications are offered as a matter of policy to all borrowers in an affected industry as is the case with these government backed loans, it will be necessary to assess the specific facts and circumstances of the borrower to determine whether this reflects an expected cash shortfall. In situations where relief through modified contractual terms is available to all borrowers, but must be applied subject to meeting certain credit quality deterioration criteria, there is a greater likelihood that use of the relief is evidence of a significant increase in credit risk (SICR) or meeting the definition of credit impaired. In some cases a borrower may take advantage of a payment holiday that provides a liquidity benefit, but does not result in the lifetime PD of the borrower increasing significantly. Determining whether a change in the timing of contractual cash flows is a SICR or evidence of a credit impaired financial asset, requires careful consideration of the specific facts and circumstances.



Other Measures to support borrowers

Measures that support the borrower to pay the amounts due under the original terms of their loan (e.g. government provided income support) can have an effect on the staging of a loan asset because it will affect the borrower's ability to repay its obligations. Such support can also affect the measurement of 12 month or lifetime expected losses as the borrower's capacity to repay is enhanced relative to the financial support not being available. It will be important for banks to assess carefully the support measures in place for borrowers and whether they will be available to its customers. Where this is not certain, an assessment of the likelihood of the availability of the support and quantum of such support will be required based on reasonable and supportable information available at the reporting date. Measures that support borrowers may improve the PD of borrowers relative to the measure not being available. However, this does not necessarily mean that all measures improve the PD of borrowers overall given the PD used for staging reflects the overall lifetime PD reflecting the broader ability of the borrower to meet its obligations when they fall due. A borrower may experience an increase in PD arising from current economic conditions that is only partly offset by government measures that are available to the borrower.



Where modifications are offered as a matter of policy to all borrowers in an affected industry as is the case with these government backed loans, it will be necessary to assess the specific facts and circumstances of the borrower to determine whether this reflects an expected cash shortfall.



Disclosures

An entity that has benefited from government assistance will need to consider the disclosure requirements in IAS 20. In particular, it should disclose the nature and extent of the government grants recognised and provide an indication of the other form of government assistance from which it has benefited. Any unfulfilled conditions and other contingencies attaching to the government assistance should also be disclosed.

IFRS 7 includes many mandatory quantitative disclosures, though the need to expand on qualitative disclosures will be critical in explaining how the current economic environment has impacted the amount, timing and uncertainty of future cash flows. In particular, disclosures should help users understand the movement of exposures through the three stages of the general ECL model and the resulting impact on recorded amounts. Given the areas discussed earlier in this publication particular consideration should be given to the disclosure requirements in IFRS 7 pertaining to how forward looking information is incorporated into the determination of ECL (IFRS 7:35G (b)), effect of modifications of contractual cash flows that have not resulted in derecognition (IFRS 7:35J) and the effect of collateral and other credit enhancements (IFRS 7:35L).

Entities should reconsider the disclosure of judgements that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements (IAS 1:122). Management may have formed new judgements in light of the current economic environment that warrant disclosure that in previous financial statements did not. Similarly, reconsideration of disclosure of sources of estimation uncertainty (IAS 1:125) will be needed given the uncertainties may have changed, or been exacerbated, since the last reporting period. ECL accounting often includes a significant degree of estimation uncertainty, but particularly so when the amount of uncertainty is higher given the various economic paths that could follow from the immediate outbreak of COVID 19 and government responses.

Contacts

If you would like to discuss these implications and other fiscal stimulus impacts on your business



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