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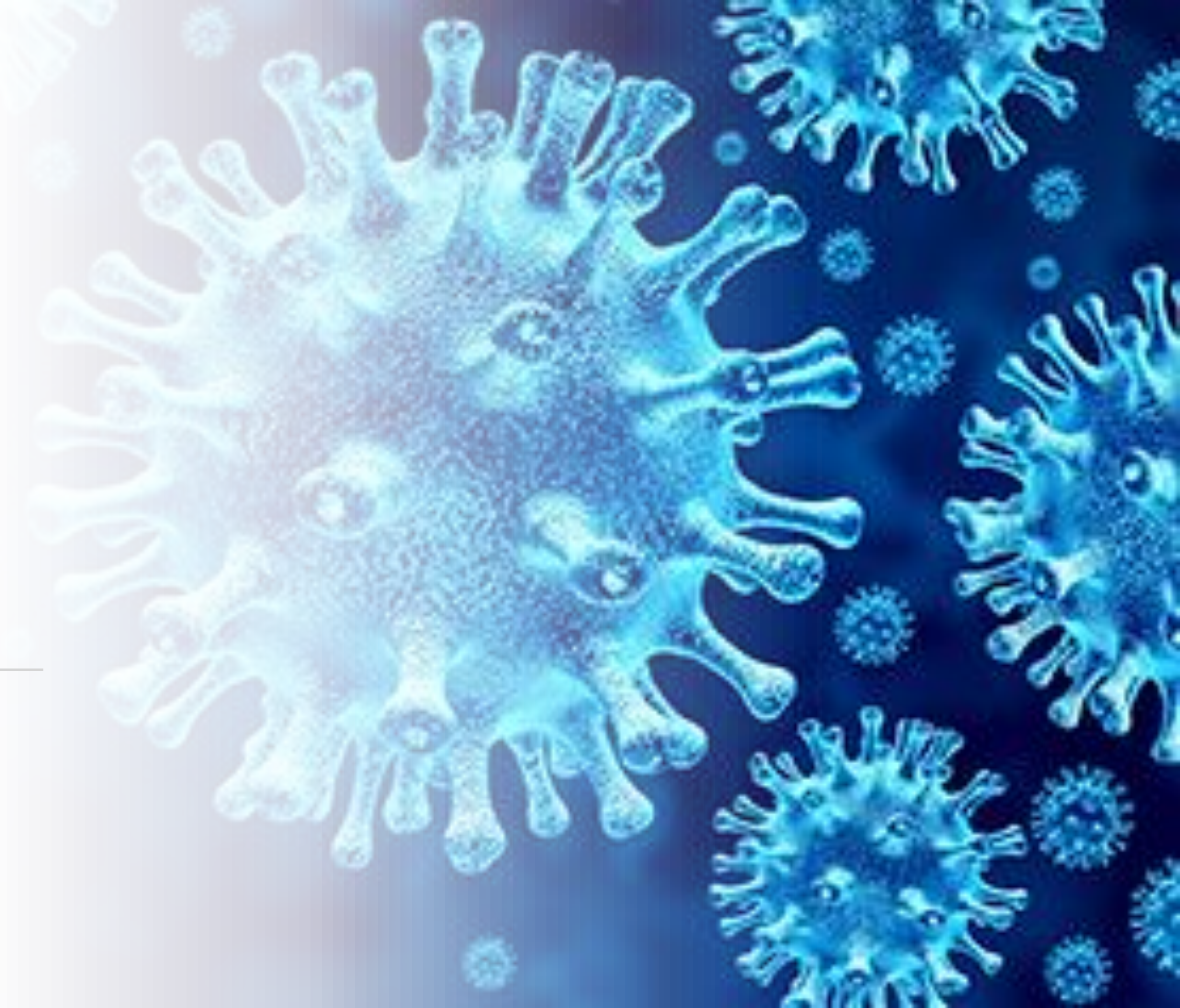
Financial Reporting

A high-level overview of the impacts of Covid-19 on Financial Reporting



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Welcome to this presentation

Presenter: Anton van Wyk M. Com CA (SA)

Anton van Wyk is a **chartered accountant** and independent consultant in International Financial Reporting Standards (IFRS and IFRS for SMEs). As former subject head of Financial Accounting at various higher education providers (including the University of Johannesburg and Monash University South Africa), he has gained valuable insights into and understanding of the important principles underlying the International Financial Reporting Standards (IFRS/IFRS for SMEs).

Anton is a well-known and popular presenter who has presented numerous IFRS updates for several accounting bodies across South Africa. He is known for his ability to simplify and highlight the most important principles contained in IFRS/IFRS f, whilst keeping the learning process enjoyable for attendees.

antonvanwykcasa@gmail.com


SCREEN ALCOHOLICS
2020
32 THINGS THAT
HAVE DEFINED
AN UPDATED CINEMATIC SHOT
NOT IN MY NAME
Attack on
one by Mob
attack on all

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Introduction "The year 2020"

- **2020: Covid-19 pandemic causes global chaos, also in SA!!**
  - Countries require businesses to suspend/cease trade
  - Lockdown/quarantine of employees and customers
  - Travel restrictions imposed (local and international)
  - Imports/exports restricted/completely suspended
  - Bans placed on tobacco products/alcohol = surge in black market sales!
- **Certain sectors impacted massively**
  - Tourism, hospitality, transportation, retail, entertainment, construction
  - Follow-on effects on manufacturing and financial sectors…
- **Difficulty to predict extent and duration of business and economic impacts (SA economy contracts, at least 2 million people lose employment, massive loss of taxes…)**
- **Massive risk in respect of consistency and comparability (e.g. unusual inputs into cost/fair value)**
- **Entities have to prepare their AFS in terms of IFRS/IFRS for SMEs, taking the above into account = not so simple!**

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The impact on Financial Reporting?

As an intro…

IAS 34 *Interim Financial Reporting*

- Accountants focus mostly on *annual* financial statements
- Focus should also be on *interim* financial statements
- Greater need to use accounting *estimates* = RISK
- Objective is that all financial information must be **reliable**, and material financial information that enhances understanding of the financial position or performance of the entity, must be appropriately **disclosed**

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IAS 8 *Changes in Accounting Policies, <u>Estimates</u> and Errors*

- Quite a pervasive consideration regarding changes in estimates
- DISTINCTION: Change in acc policy vs change in estimate
- Changes in accounting estimates are accounted for prospectively, and not retrospectively
- Careful: distinguish between RECOGNITION and MEASUREMENT when making estimates
  - Recognition: be careful of non-adjusting events after the reporting period
  - Measurement: consider information up to date of authorisation of AFS for issue
- Make necessary disclosure in the notes to the AFS (line-items affected, nature of change in estimate & reason, financial effect, if not practicable – reason for such etc.)

IAS 10 *Events after the Reporting Period* (1)

TIMELINE OF COVID-19

- Late 2019: a cluster of cases displaying the symptoms of a “pneumonia of unknown cause” was identified in Wuhan, the capital of China’s Hubei province

- 31 December 2019: China alerts the World Health Organisation (WHO) of this new virus

- 30 January 2020: the International Health Regulations Emergency Committee of the WHO declares the outbreak a “Public Health Emergency of International Concern”.

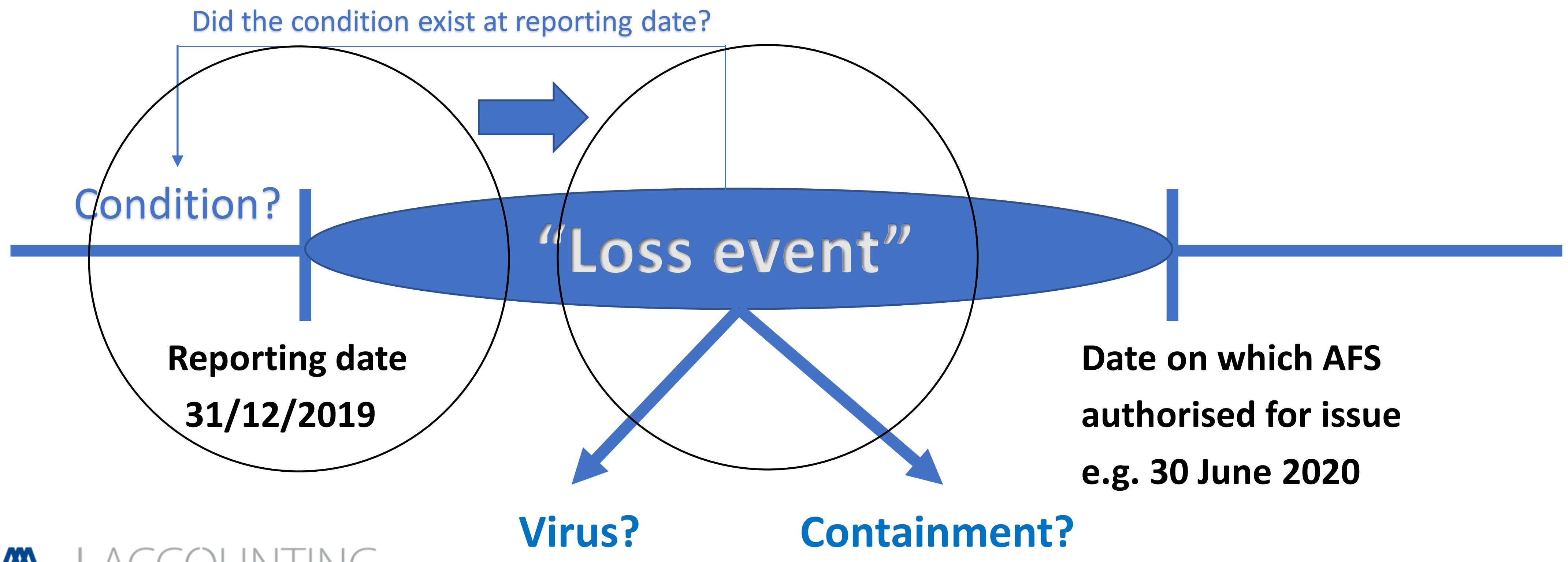
- After 30 January 2020: more cases diagnosed, also in other countries. Measures were taken and policies imposed by China, and other countries. Gradually more information became available.

Question: What caused the loss event? The virus, or the containment measures?

IAS 10 *Events after the Reporting Period* (2)

- Two types of events in IAS 10:
  - **Adjusting event**: provides evidence of condition(s) that existed at the end of the reporting period
  - **Non-adjusting event**: indicative of condition(s) that arose after the reporting period
- Remember the "golden period" – from reporting date to date of authorisation for issue of the AFS: events in this period must be closely scrutinised!
- Primary factor is the reporting date *(31 December 2019 is a crucial date)*
- **Professional judgement is required – what is the condition? *(virus versus measures?)***
- Each entity will have to assess their unique circumstances and information
- **Consensus:**
  - Reporting date at/before 31 December 2019 = effects of Covid-19 are **non-adjusting** events
    - Reason: condition not yet existed by 31 December 2019
  - Reporting date after 31 December 2019 = likely to be **adjusting events**

IAS 10 *Events after the Reporting Period* (3)



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IAS 10 *Events After the Reporting Period* (4)

- **What must the accountant do?**

  - **<u>Adjusting event:</u>** journal entries to adjust the AFS to reflect impact of Covid-19, PLUS necessary disclosure in the notes to the AFS where required

  - **<u>Non-adjusting event:</u>**
    - if material, provide note disclosure (nature of event, financial effect)
    - If no reliable quantified estimate: still provide qualitative information, plus a statement in the notes that a reliable estimate could not be made
    - Examples of typical *non-adjusting events* after the reporting period *(i.e. conditions did not exist at reporting date)*:
      - **Breaches** of loan covenants (restrictions on actions of the borrower/lender)
      - Management **plans** to discontinue an operation/implement a major restructuring
      - Significant **decline** in the fair value of investments held
      - Abnormally large **changes** in asset prices

Example

ABC (Pty) Ltd has a February financial reporting date. The company is incorporated in South Africa. On 27 March 2020, the SA government implemented Level 5 lockdown restrictions relating to Covid-19. The company authorised their AFS for issue on 30 June 2020.

ABC (Pty) Ltd made the following payments on 31 May 2020, relating to Covid-19, to family members of employees who succumbed to Covid-19:

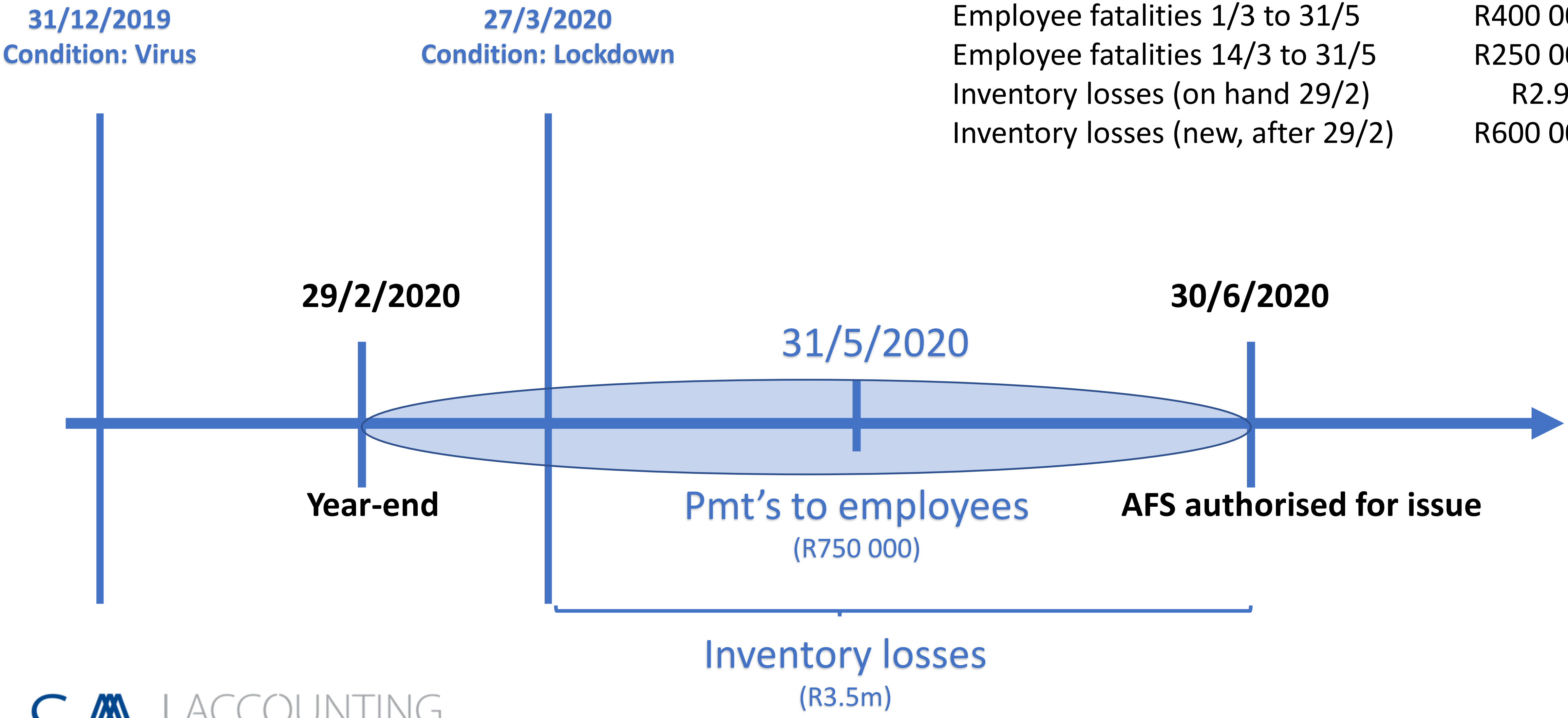
➢ Passed away up to 29 February 2020	R100 000
➢ Passed away from 1 March 2020 to 31 May 2020, already sick at 29 Feb 2020	R400 000
➢ Passed away from 14 March 2020 to 31 May 2020, not sick at 29 Feb 2020	R250 000

No further employees succumbed to the disease

Between 27 March 2020 and 30 June 2020, ABC (Pty) Ltd wrote off obsolete perishable inventory (that was on hand on 29 February 2020) with a total cost price of R2.9 million. The company bought perishable inventory with a cost price of R800 000 during March 2020, of which R600 000 had to be written off as obsolete during the period 27 March 2020 to 30 June 2020. The inventory obsolescence was caused by an inability to trade during the national lockdown restrictions.

Losses due to Covid-19

Employee fatalities up to 29/2	R100 000
Employee fatalities 1/3 to 31/5	R400 000
Employee fatalities 14/3 to 31/5	R250 000
Inventory losses (on hand 29/2)	R2.9m
Inventory losses (new, after 29/2)	R600 000



Accounting requirements

Employee fatalities (adjusting events: condition = virus = existed at year-end)

<u>29/2/2020</u>

Dr Employee benefits (P/L)	R500 000	
Cr Provision for employee benefits (SoFP)		R500 000

(including tax consequences)

Inventory losses (non-adjusting events: condition = lockdown = arose after year-end)

<u>29/2/2020</u>

N/A (no journal entries)

Disclosure in notes relating to inventory losses (IAS 10) →

Loss event (details)
Losses suffered (ZAR)
Impact on going concern?

IAS 1 *Presentation of Financial Statements* (1)

- Going concern -

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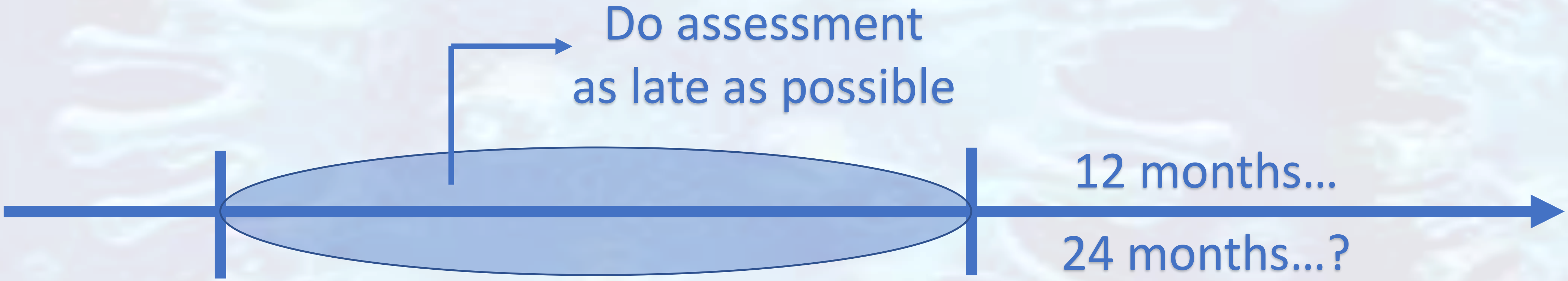
- IAS 1 requires management to assess an entity's ability to continue as a **going concern**
  - Is it appropriate to conclude that *going concern* is an underlying assumption of the AFS?
- This assessment covers reporting date up to the date that the AFS are issued
- Assessment considers at least 12 months after the reporting date, or after the date the AFS are authorised for issue
  - Covid-19 impact so severe, that the above period could be extended
- Material uncertainties that cast significant doubt on the entity's ability to operate as a going concern, must be **disclosed** in the AFS
- Wide range of factors to be considered, e.g. travel bans, trade restrictions, government assistance, potential sources of replacement financing, financial health of suppliers and customers, effects on key financial performance ratios (liquidity, solvability, debt:equity etc.)

Going concern assessment
(in the light of Covid-19)



Reporting date (y/e)

AFS authorised for issue

IAS 1 *Presentation of Financial Statements* (2)

- Disclosure -

- IFRS requires **disclosure** of **significant estimates and key assumptions** in AFS, and this becomes especially relevant due to Covid-19…
- Assessments must include different scenarios with varying assumptions which can be updated to incorporate the evolving nature of uncertainties ("sensitivity analyses" – indicates volatility caused by assumption changes)
- If the company decides to liquidate, or has no realistic alternative but to do so, the underlying basis of "going concern" is no longer applicable and another basis should be used to prepare the AFS, e.g. the liquidation basis

<u>Crux:</u> Disclose estimates, assumptions and judgements

IAS 1 *Presentation of Financial Statements* (3)
- Disclosure -

- Pervasive objective (crux) and examples of disclosures
  - IAS 1 requires disclosure of information about the **assumptions** concerning the future, and other major sources of **estimation uncertainty** at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities, such as noncurrent assets subject to impairment, within the next financial year (with the exception of assets and liabilities measured at fair value based on recently observed market prices)
  - Examples of the types of disclosures that an entity is required to make include:
    - The nature of the assumption or other estimation uncertainty
    - The sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity
    - The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected
    - An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved

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IAS 12
Income Taxes

- **Deferred tax assets** represent:
  - Unused tax credits/tax losses that can be used to reduce future taxable income (i.e. FEB = tax saving)
  - Deductible temporary differences for which sufficient future taxable temporary differences are expected to exist to reverse such deductible temporary differences (i.e. future tax reductions)

- The recognition of deferred tax assets will therefore have to be reconsidered, in terms of an entity's ability to utilise the above
  - i.e. the **recoverability** of an entity's deferred tax assets needs to be reconsidered i.t.o. Covid-19

IFRS 13
Fair Value Measurement (1)

"an exit price at the measurement date from the point of view of market participants"

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- Big focus of IFRS 13 is to disclose in the AFS the valuation techniques, inputs used in valuations and sensitivity of the valuation to changes in assumptions (inputs)
- **In a FVM: What conditions (and the corresponding assumptions) were known/knowable to market participants <u>at the reporting date</u> ("current market conditions" = NB), not future conditions!!!**
  - **Be careful of hindsight accounting!!**
- Biggest impact = on financial instruments and investment properties, especially i.r.o. how market participants would respond to Covid-19 in their assumptions when they price these assets (especially where valuations needed (Level 3 inputs))
- Massive volatility in market prices, which could have impact on quoted prices (Level 1) and observable inputs into valuation techniques (Levels 2 and 3)

IFRS 13 *Fair Value Measurement* (2)

"an exit price at the measurement date from the point of view of market participants"

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- The impact on FVM would depend on the evaluation of whether the severity of the outbreak at the reporting date would have impacted market participants' valuation assumptions <u>at that date</u>
- Accordingly, entities need to evaluate whether its severity, potential impact and the related valuation inputs were known or knowable by market participants by means of usual and customary due diligence performed up to that date
- The information available to the market at the reporting date may be relevant in making this evaluation. This would include any corroborative or contrary evidence such as the timing and trajectory of observable market price movements of related assets in the relevant markets, as well as information from other than usual sources of market data up to the reporting date

IAS 36 *Impairment of Assets*

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- **Affects non-financial assets (excluding inventory), not measured at fair value**
- Impairment test done when indicator exists, except goodwill & intangible assets with indefinite useful life
- IAS 36 ensures that a non-financial asset is not subsequently measured at higher than its **recoverable amount (RA)**
  - RA = higher of:
    - Value in use (PV of future cash flows)
    - **Fair value** less costs to sell (IFRS 13)

Link to IAS 10: subsequent event indicates possible impairment…
Did the condition exist at reporting date?

- Covid-19 is a macro and micro economic indicator that a non-financial asset may be impaired – the recoverable amounts for non-financial assets will therefore have to be considered
- Assets affected by IAS 36's impairment testing principles are **PP&E** (cost or revalued), **intangible assets** (cost or revalued), **goodwill** (business combinations), **RoU assets** (at cost), **investment property** (at cost), **biological assets** (at cost), **investments in associates and joint ventures** (equity accounted)
- Also a follow-on impact on deferred tax (likely to reduce deferred tax liabilities)

IAS 2 *Inventories*

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- IAS 2 has its own "built-in" impairment test
- Inventories are subsequently measured at the lower of:
  - Cost (this is also a Covid-19 risk due to unusual/abnormal costs having to be excluded)
  - Net realisable value (NRV)
- More detailed assumptions and impairment assessments will have to be made
- Consequence would be potential inventory write-downs (obsolete, slow-moving, redundant etc.)
- Interim inventory impairment losses to be reflected in interim financial statements already, subsequent recoveries as gains in the AFS

IAS 16 *Property, Plant and Equipment*

- Biggest impact = consideration of:
  - Remaining useful life (especially time-based)
  - Depreciation (time-based) should have continued during lockdown/non-operation
  - Residual value of asset at end of useful life
  - Capitalisation of unusual costs to the cost price of the asset (e.g. very long storage in customs/harbours or very expensive transport costs etc.) – consider consistency and comparability
  - Link to IAS 8 *Changes in Accounting Policies, <u>Estimates</u> and Errors*
    - Make the necessary disclosure!
- Also: Fair value (revaluations) i.t.o. IFRS 13!

IAS 38 *Intangible Assets*

(very similar to PP&E)

- *Biggest impact = consideration of:*
  - *Remaining useful life (especially time-based)*
  - *Amortisation (time-based) should have continued during lockdown/non-operation*
  - *Residual value of asset at end of useful life*
  - *Capitalisation of unusual costs to the cost price of the asset (e.g. delays in R&D processes etc.) – consider consistency and comparability*
  - *Link to IAS 8 Changes in Accounting Policies, Estimates and Errors*
    - *Make the necessary disclosure!*
- Also: Fair value (revaluations) i.t.o. IFRS 13!

IFRS 9 *Financial Instruments* (1)

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- Impairment of financial assets NOT measured at fair value = greatest focus of IFRS 9
  - @FVTOCI/@FVTPL = OK
  - @Cost/@Amortised cost = risk!!
- IFRS 9 does not require a credit event to occur before impairment testing is to be performed on financial assets
- For all financial assets, it should annually be determined whether there has been a significant increase in credit risk since initial recognition, with or without a credit event/impairment indicator (hence ⇧ in credit risk = focus)
  - If not: recognise 12-month expected credit losses (ECLs)
  - If so: recognise lifetime expected credit losses (ECLs)
- Significant increases in credit risk (since initial recognition of FA) due to Covid-19, is therefore a very big focus point, could lead to a change from 12-month ECLs to lifetime ECLs!
- Link to IAS 10 *Events After the Reporting Period* – does an IAS 10 loss event provide more information about a condition that already existed at reporting date? Adjusting/non-adjusting event? Did credit risk increase?
- Authorities across the world are issuing guidance on how to interpret the changes in credit risk and the impacts thereof on ECLs etc.

IFRS 9 *Financial Instruments* (2)

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- ECL is a probability weighted amount that is determined by evaluating a range of possible outcomes
- Qualitative and quantitative disclosure enables users of financial statements to understand the effect of **credit risk** on the amount, timing and uncertainty of future cash flows
  - This includes the basis of inputs and use of assumptions and estimation techniques

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IFRS 7 *Financial Instruments: Disclosures*

- Disclosure is required of
  - defaults and breaches of loans payable
  - gains and losses arising from derecognition or modifications
  - reclassifications from the OCI cash flow hedge reserve that results from hedged future cash flows no longer being expected to occur
- Disclosures include **quantitative** data, for example about liquidity risk, and **narrative** disclosure, for example how risk is being managed

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IFRS 15 *Revenue from Contracts with Customers*

- Link to contract modification related to variable consideration, which is estimated at initial recognition!
- Revenue is recognised when performance obligations identified in the contract, are satisfied (either over time, or at a point in time)
- Could be an effect on assumptions made in respect of measuring revenue relating to goods/services **already delivered**
- Reduced demand could lead to:
  - Increased expected returns
  - Additional price concessions
  - Reduced volume discounts
  - Penalties for late delivery
  - Reduction in prices that can be obtained by customer
- Entity may also modify its enforceable rights or obligations under a contract with a customer such as granting a price concession – it is then necessary to consider whether the concession is due to resolution of variability that existed at contract inception or a modification that changes the parties’ rights and obligations

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IFRS 16 *Leases*

31

- Biggest Covid-19 impact = concessions ("rent holidays") to commercial lessees
- Were the changes part of the original Ts&Cs of the lease?
- Changes could be agreed between parties, or imposed by governments – these are to be treated the same way
- **Is the change a "lease modification"?**
  - IFRS 16 defines a *lease modification* as a **change in the scope of a lease**, <u>or</u> **the consideration for a lease**, that was not part of the original terms and conditions of the lease
    - Rent concessions alone, are not changes in the scope of the lease
    - It should be carefully assessed whether the consideration for the lease, has actually changed… a 3-month concession can be recouped through subsequent increased lease instalments – then there is no change in consideration
- If a lease modification occurred, the entity then assesses whether the change was part of the original Ts&Cs of the lease *(if so, it is not a lease modification)*
  - Consider all possible facts and circumstances (even if not contemplated: if linked to original Ts&Cs, there is no lease modification)
- Lease modification: treat as a new lease
- No lease modification: treat as variable lease consideration (expense to P/L)
- Remember: adequate disclosure (IFRS 16 and IAS 1)

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

- Issues to consider:
  - **Provisions** should be reconsidered (recognition and measurement, but recognition should not be adjusted for non-adjusting events after reporting period!)
  - **Contingent liabilities** to be reconsidered based on the Covid-19 impact (two types!!)
  - **Onerous contracts**
    - IAS 37 requires a provision to be made the moment that a loss is expected from a contract that an entity is legally committed to
    - Determine the least net cost of exiting (i.e. fulfilment versus cancellation, if possible)
    - Measure @PV and unwind as interest expense if fulfilment option is selected
    - Disclosure of the information surrounding the onerous contract
  - **Provision for restructuring**
    - Consider legal obligation (i.e. contracts to restructure are in place) versus constructive obligation (ACTION: entity announced plan with sufficient features; REACTION: identified employees have an expectation to be affected)
    - Disclose

Example: Onerous contract

On 29 February 2020, ABC Limited decides to no longer rent its head office building and to vacate with immediate effect. They are allowed, in terms of the lease agreement, to **sublease** the building to another tenant. The information relating to the lease, is as follows at the above date:

- Remaining lease term 48 months
- Monthly instalment R250 000 (ignore VAT)
- Sublease instalment R175 000 (ignore VAT)
- Appropriate discount rate = 8% per annum, nominal and pre-tax
- Lease cancellation penalty = R5 million

Solution

29 February 2020

Dr Loss from onerous contract (P/L)	R3 072 143	
Cr Provision for onerous contract (SoFP)		R3 072 143

(FV = 0, I/Yr = 8%, N = 48, P/Yr = 12; Pmt = R75 000; PV = ?)

28 February 2021

Dr Lease expense (P/L) (12 x R250 000)	R3 000 000	
Cr Bank		R3 000 000
Dr Bank	R2 100 000	
Cr Lease income (P/L) (12 x R175 000)		R2 100 000
Dr Provision for onerous contract	R900 000	
Cr Lease expense (P/L)		R900 000
Dr Interest expense (P/L)	R221 242	
Cr Provision for onerous contract (SoFP)		R221 242

IFRS 5 *NCAHFS and Discontinued Operations*

- Entity can decide to dispose of a non-current asset BEFORE the originally intended date of disposal = trigger for impairment test i.t.o. IFRS 5
- NCAHFS are principally recovered through a sales transaction, and not continued use
- NCAHFS to be measured at lower of their carrying amounts and FV-CTS on date of reclassification into IFRS 5
- Depreciation ceases immediately when intention changes
- Deferred tax should be adjusted to reflect recovery through sale, and not through continued use (i.e. estimated CGT and recoupments)
- Entity can also dispose of group of assets and liabilities together in a single transaction = DISPOSAL GROUP
- Some disposal groups can be large enough to satisfy the concept of a discontinued operation
  - Presentation (especially in P/L: separate discontinued operations from continuing operations)
  - Disclosure (details about the discontinued operation)

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THANK YOU FOR ATTENDING THIS SESSION

KEEP WELL AND TAKE CARE

Sources consulted and/or interesting reads

- https://www.ifac.org/knowledge-gateway/supporting-international-standards/discussion/financial-reporting-implications-covid-19
- https://cdn.ifrs.org/-/media/feature/supporting-implementation/ifrs-16/ifrs-16-rent-concession-educational-material.pdf?la=en
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