Income Statement Presentation of COVID-19 Impacts

Extract, IFRS® Discussion Group Report on the Meeting – September 23, 2020

The COVID-19 pandemic is having a significant economic effect on companies, many of which have experienced a significant reduction in revenue and incurred various expenses or loss as a result. In addition, some companies may have obtained government grants under various COVID-19 relief programs. When preparing interim and annual financial statements in accordance with IFRS® standards, management will need to consider how to present these COVID-19 related expenses and income in the income statement.

IAS 1 *Presentation of Financial Statements* contains guidance for the presentation of items in the income statement:

- Paragraphs 99- 105 of IAS 1 require an entity to present an analysis of its expenses classified based on their function (e.g., cost of sales, distribution and administration) or their nature (e.g., depreciation, purchase of materials and employee benefits), whichever provides reliable and more relevant information. This classification of expenses may be presented on the face of the income statement or in the notes and should be applied consistently from period to period.
- Paragraph 85 of IAS 1 requires that an entity present additional line items, headings and sub-totals in the income statement when such presentation is relevant to understanding the entity's financial performance. When an entity elects to present a separate subtotal for "income from operations", paragraph BC56 in the Basis for Conclusions to IAS 1 provides guidance on items that should be included in that subtotal.
- Paragraph 97 of IAS 1 also requires that when items of income or expense are material, an entity shall disclose their nature and amount separately, either in the income statement or in the notes to the financial statements.

The Group discussed four issues related to classifying and presenting various income and expense items related to COVID-19 in the income statement.

Issue 1: Consider the following examples. How should an entity classify the income and expenses related to COVID-19 in its income statement?

(a) **Expenses that continue to be incurred during COVID-19**: the entity may continue to incur certain expenses, such as wage and salaries for idled employees, during COVID-19 that are the same or similar to those incurred prior to COVID-19.

(b) **Expenses that are similar to those incurred before COVID-19 but are higher in amount***:* for example, an entity may decide to pay its employees additional wages, such as temporary hazard pay, during the pandemic.

(c) **New items of income or expense that were earned or incurred because of COVID-19** (i.e. they would not have been earned or incurred if COVID-19 had not occurred). Examples of these items include:

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- Additional costs incurred to clean and disinfect facilities
- Penalties for delayed or non-performance under contracts invoked directly as a result of the pandemic
- Rent concessions from lessors that occur as a result of COVID-19
- Recoveries from business interruption insurance where the policy covers claims arising from the pandemic
- Impairment loss arising directly from the impact of COVID-19

Analysis

Paragraph 45 of IAS 1 underscores the principle that financial statement presentation should be consistent from period to period. Therefore, when assessing the classification of these income or expenses items described above, management should consider the existing structure of the entity's income statement.

Expenses that continue to be incurred during COVID-19

Given these expenses were incurred before COVID-19, they should be classified based on their existing classifications in the entity's income statement. For example, if the entity classified the expenses by function, it would allocate the salary and wages for idle employees to the related functions. If the expenses are classified by nature, they are allocated to the existing line items in the income statement (e.g. employee benefit expense).

In addition, these expenses should be presented consistently period over period. They should not be "carved out" of existing line items in the income statement and presented separately.

Expenses that are similar to those incurred before COVID-19 but are higher in amount

Similar to the analysis above, given these expenses are similar to those incurred before COVID-19, the entity should classify them based on its existing classification of expenses (i.e. by function or by nature).

New income or expenses that were incurred because of COVID-19

In addition to considering the existing structure of its income statement, the entity should assess whether any of these incremental income or expense items should be presented as separate line items on the income statement. Doing so would be appropriate when such presentation is relevant to a user's understanding of the entity's financial performance. In making this determination, the entity needs to apply judgment and consider factors such as materiality and the nature and function of the items of income and expense. The entity should not describe any items of income or expense as "extraordinary items."

Where a new income or expense item arising from COVID-19 is material and is not presented separately on the income statement, its nature and amount should be disclosed. Such disclosure should be clear and transparent, describe how the item was earned or incurred in the context of COVID-19, and indicate where the amount is presented in the income statement.

The Group's Discussion

Group members agreed with the analysis, highlighting the principles in paragraph 45 of IAS 1 requiring an entity to have a consistent financial statement presentation from period to period.

Some Group members observed that in practice, many entities have chosen to detail how COVID-19 has impacted their financial performance through note disclosures and discussion in their Management Discussion and Analysis (MD&A) instead of changing their income statement presentation. These Group members supported this practice as it retains consistent income statement presentation while highlighting material, relevant information to financial statement users. One Group member observed that in practice, the indirect impacts of COVID-19, such as increased sales for certain products or higher prices for certain commodities, are often included in the MD&A instead of the financial statements. Therefore, this Group member thought that financial statement users should consider the information included in both the financial statements and the MD&A to have a complete understanding of COVID-19's impacts on an entity's performance.

Issue 2: If the entity presents a sub-total in its income statement for "income from operations", should it present COVID-19 related items within this sub-total?

Analysis

While IAS 1 does not define "income from operations," paragraph BC56 of the Basis for Conclusions on IAS 1 notes that "it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount."

Therefore, it would not be appropriate for the entity to exclude COVID-19-related income or expenses from "income from operations" solely because they may be non-recurring or unusual. For example, in addition to restructuring expenses and inventory write-downs, cleaning expenses are typically part of operating expenses and presented as part of "income from operations". As such, incremental cleaning and sanitization expenses incurred to prevent the spread of COVID-19 may be unusual, but they are clearly related to operations and should be presented in "income from operations".

The Group's Discussion

Group members agreed with the analysis. They thought that income or expenses incurred to operate the business during the pandemic should be presented in "Income from operations". One Group member commented that an entity can provide additional information on its COVID-19 related expenses in the notes to the financial statements to help users better understand the cash flow impacts from the pandemic.

Fact Pattern for Issue 3

- Entity A has a factory that was closed or operated significantly below normal capacity from March to July 2020 due to the government imposed COVID-19 restrictions. During this period, Entity A continued to pay normal salary to its manufacturing employees while they were unable to work. Entity A also continued to depreciate its factory on a straight-line basis.

- Entity A capitalizes to inventory an allocation of fixed production overheads (such as factory depreciation) based on the factory's normal production capacity. The amount of fixed overhead allocated to each unit of production is not increased because the factory is idle or operating below normal capacity. Instead, unallocated fixed overheads are expensed in the period incurred in accordance with paragraph 13 of IAS 2 *Inventories*.
- Salary and wage continuance costs incurred while the factory is idle or operating below normal capacity are treated as "abnormal amounts" of labour and are expensed in the period incurred in accordance with paragraph 16(a) of IAS 2.

Issue 3: If Entity A classifies expenses by function and presents a separate line item for cost of goods sold (COGS), should it classify the unallocated fixed overheads and direct labour costs as part of COGS?

Analysis

Paragraph 38 of IAS 2 states that "the amount of inventories recognised as an expense during the period, which is often referred to as **cost of sales**, consists of those costs previously included in the measurement of inventory that has now been sold and **unallocated production overheads and abnormal amounts of production costs of inventories**. The circumstances of the entity may also warrant the inclusion of other amounts, such as distribution costs. [**emphasis added**]" Therefore, Entity A is required to include the unallocated fixed overhead costs and labour costs incurred while the factory was closed or operated significantly below normal capacity in COGS. This would result in a lower gross margin, all else being equal.

The Group's Discussion

Group members agreed with the analysis.

Some Group members commented that if an entity chooses to present the impact of COVID-19 separately from the COGS line item, it should also present separately all other material impacts of COVID-19 in other parts of its income statement. This will ensure that the income statement's presentation is balanced in highlighting material income and expenses directly attributable to the pandemic. One Group member observed that separating all material impacts of COVID-19 in the income statements may be difficult in practice when multiple financial statement line items are affected. In such cases, highlighting COVID-19's impact in COGS without also explaining its material impacts on other financial statement line items would not provide a complete picture of how the pandemic has affected the entity's financial performance.

Fact Pattern for Issue 4

- A manufacturing company has received $400,000 under the Canada Emergency Wage Subsidy (CEWS) program for the salaries and wages paid to its employees working in manufacturing and administration.[1] Specifically, $250,000 relates to salaries and wages paid to employees

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[1] CEWS is a grant program the government of Canada offers to compensate entities for continuing to pay salaries and wages to employees even if they are not providing active service due to COVID-19. To be eligible for the CEWS, an entity must have suffered a minimum revenue drop during the period March-July 2020. Subsequent to July 2020, there is no requirement for there to be a revenue drop to be eligible for the subsidy, however the decrease in revenue is factored into the calculation of the subsidy amount.

working in manufacturing and $150,000 relates to salaries and wages paid to employees working in administration.

- The company presents expenses by function. During the period covered by the CEWS, no inventory was produced and all salaries and wages relating to manufacturing were appropriately expensed and presented in "COGS." All salaries and wages relating to administration were expensed and presented in "Selling, general and administration".

Issue 4: How should the company present CEWS received on its income statement?

Analysis

Paragraph 29 of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* provides entities with a choice to present grants related to income as part of profit or loss, either separately or under a general heading such as "Other income" or alternatively as a deduction in reporting the related expense. Therefore, the company has a policy choice in how to present the income from the CEWS. The following table illustrates, depending on the IAS 20 policy choice elected, several potential approaches to presenting the grant income in the income statement where expenses are classified by function therein.

(Amount in thousands of Canadian dollars)		**After the CEWS grant**		
	Before the CEWS	**Approach #1:** present grant income adjacent to the related expenses	**Approach #2:** present grant income as a separate line	**Approach #3:** present grant income as a deduction from the related expenses
Revenue	$1,000	$1,000	$1,000	$1,000
Cost of goods sold	(300)	(300)	(300)	(50) (note (c))
Grant income	-	250 (note (a))		-
Gross profit	700	950	700	950
Other income	100	100	100	100
Selling, general and administration	(200)	(200)	(200)	(50) (note (c))
Grant income	-	150 (note (a))	400 (note (b))	-
Other expenses	(80)	(80)	(80)	(80)
Profit before income taxes	$520	$920	$920	$920

Note (a) – Grant income of $400 was recognized in the year, of which $250 is attributable to salaries and wages recognized in cost of goods sold, and $150 is attributable to salaries and wages recognized in selling, general and administration expenses.
Note (b) – Grant income of $400 was recognized in the year, which is attributable to salaries and wages paid to manufacturing and administration employees.
Note (c) – Grant income of $400 was recognized in the year. Cost of goods sold of $300 and Selling, general and administration expenses of $200, were reduced by grant income of $250 and $150 respectively attributable to salaries and wages included within those respective line items.

Please note: The above notes are meant to explain the line items in the above income statement and do not purport to be the full disclosures required when grant income is recognized in the financial statements. For such required disclosures, refer to paragraph 39 of IAS 20.

Under Approach #2 in the table above, different views exist in practice as to whether the grant income should be presented as part of "income from operations." Some think it should be presented within “income from operations” because the grant subsidizes an operating expense (i.e., salary and wages). Others note that paragraph 29 in IAS 20 permits grant income to be presented as “other income,” which can be outside of “income from operations” as the grant is economic relief obtained as a result of a pandemic, which is not in the ordinary course of the entity’s operating activities.

The Group’s Discussion

The Group noted that IAS 20 provides an entity the choice to present grant income as part of profit or loss, either separately or under a general heading such as “other income” or alternatively as a deduction from the related expense. Therefore, they agreed that all three approaches are acceptable. They also thought that note disclosure for the grant income and the related expenses helps financial statement users better understand the impact of the grant on cash flows. One Group member highlighted that entities need to consider their past practice of presenting government grant income to ensure consistency with financial statement presentation before the pandemic.

Some Group members preferred Approach #3. They thought Approach #3 better reflects the net impact of COVID-19 after considering the associated grant income. One Group member thought Approach #2 provides the most distorted gross profit amount amongst the three approaches as it does not reflect the grant income attributable to COGS, resulting in a low gross profit.

The Group then discussed different alternatives as described in the analysis to present grant income as part of “income from operations” under Approach #2. Some Group members supported the view that grant income can be presented as part of “income from operations” as the grant is subsidizing an operating expense.

One Group member noted that paragraph 12 of IAS 20 states that the “government grants shall be recognized in profit or loss on a systematic basis over the periods in which the entity recognizes as expenses the related costs for which the grants are intended to compensate.” Therefore, this Group member commented that if inventory is produced in the period and the government grant is subsidizing the costs that are included in the cost of inventory, then the grants should be recognized in profit or loss in the same period as the inventories are sold and the associated COGS recognized.

Overall, the Group’s discussion on Issues 1 to 4 raised awareness of the potential impact that COVID-19 may have on an entity’s income statement presentation. No further action was recommended to the AcSB.