Financial Reporting Considerations of COVID-19

Extract, IFRS® Discussion Group Report on the Meeting – May 27, 2020

Many businesses are impacted by the COVID-19 pandemic. Impacts include, but are not limited to, operational impacts (including lost revenues, disrupted supply chains, unavailability of employees, and closure of facilities) and liquidity issues (collectability issues as a result of COVID-19's impact on customers, inability to raise financing, and negative impact on compliance with debt covenants). The outbreak has also resulted in significant volatility in major financial and commodities markets worldwide. This has resulted in volatility in share price for many entities. To assist individuals and businesses affected by this pandemic, the federal, provincial and other global governments have announced various support programs.

As a result of the impact of COVID-19 as noted above, there may be significant impacts to a number of financial accounting areas.

The Group discussed five potential accounting issues related to COVID-19. These issues are not exhaustive. Entities should consider their own circumstances when analyzing the financial impacts of COVID-19.

Issue 1: How does COVID-19 affect an entity's impairment assessment of non-financial assets?

Analysis

An asset or a cash generating unit (CGU) is impaired when its recoverable amount, being the higher of its fair value less costs of disposal (FVLCD) and its value in use, is less than its carrying value. Value in use is the present value of the future cash flows expected to be derived from an asset or a CGU. This present value calculation incorporates an estimate of expected future cash flows and expectations about possible variations of such cash flows. The FVLCD of an asset or a CGU reflects market participant assumptions of the fair value based on the requirements of IFRS 13 *Fair Value Measurement.*

Entities are required to assess at each reporting period if there are indicators that an asset or a CGU may be impaired by considering both external and internal sources of information.

Assessing impairment indicators

As a result of the business disruptions caused by COVID-19, it is reasonable to expect that many businesses will identify potential impairment indicators from both internal and external sources. Entities should further analyze their own circumstances to determine whether these potential impairment indicators would result in performing an impairment test in accordance with IAS 36 *Impairment of Assets*.

When performing this assessment, an entity should consider events and information received after the reporting period only if this information provides additional evidence of conditions that existed at the end of the reporting period.

<u>Performing impairment tests</u>

For the value-in-use calculation, management needs to apply significant judgment in preparing forecasts and budgets when estimating the length and severity of the economic impact from COVID-19. To reflect these judgments and the uncertainty in this calculation, management may find an expected cash-flow approach based on probability-weighted scenarios to be more appropriate than a single best estimate. Significant judgment may also need to be applied in estimating the FVLCD of the asset or the CGU as the significant reduction in market transaction activities can result in fewer comparable transactions available for use in developing an estimate of fair value. Inputs other than forecasts, such as an entity's discount rate may need to be adjusted to reflect changes in the market, changes in risk, or increased uncertainty arising from COVID-19. Enhanced disclosure may be required for these key assumptions used and judgment made in estimating the recoverable amount.

Due to the increased volatility in the financial markets, market capitalization for many entities will be reduced. Some entities' market capitalization may be less than their net assets' carrying value (also known as a market cap deficiency). In such cases, these entities should consider preparing an analysis to explain the difference between the market capitalization and the recoverable amount of the assets or the CGUs. Entities that prepare interim financial statements should assess whether there are indicators of impairment for any goodwill recognized at the interim date, even though their annual test date is not during the interim period. If indicators of impairment exist, an impairment test needs to be performed. Any impairment loss recognized for goodwill at the interim period cannot be reversed at subsequent reporting dates, in accordance with IFRIC 10 *Interim Financial Reporting and Impairment*.

The Group's Discussion

Group members agreed with the above analysis.

Group members highlighted the importance of evaluating both internal and external factors when assessing whether there are indicators that assets may be impaired as the result of the COVID-19 pandemic. One Group member noted that an economic downturn, in its own right, does not automatically trigger an impairment test. This member thought that management should consider an entity's specific circumstance, such as the forecast of mid to long term growth rates and industry performance, when identifying impairment indicators. Some Group members commented that when the carrying amount of an entity's net assets exceeds its market capitalization, management should carefully review the inputs to the value-in-use and FVLCD determinations when performing the impairment test. They also thought that management should consider qualitatively assessing the reasonability of the impairment test by reconciling the entity's market capitalization to the recoverable amount of the assets or the CGUs.

The Group noted some practical challenges in performing the value-in-use calculation. Some Group members observed that in certain situations, a significant estimate in the value in use calculation is the terminal value. They noted that management needs to ensure that maintainable earnings are used to calculate this value. One Group member commented that any change in timing of cash flows and the additional cash flows from government grants could impact the present value calculation and should be carefully analyzed.

Group members also discussed the impact of IFRIC 10 and goodwill impairment assessments in an interim period. A few Group members noted the evolving conditions of COVID-19 creates uncertainties, requiring management to exercise significant judgement when assessing the recoverability of cash generating units with significant goodwill. These judgements will need to be well supported and balanced. Therefore, they should not be overly pessimistic or optimistic. The Canadian Securities Administrators (CSA) representatives commented that individuals with governance roles should review the assumptions made by management in the impairment analysis. In addition, given the significant judgements and assumptions made in recoverability calculations, management should consider discussing these matters with their auditors when they are preparing the interim financial statements.

The Group emphasized the need for robust disclosure of assumptions and judgements made in light of the unprecedented uncertainty this pandemic is causing. A CSA representative noted that guidance was published to assist issuers when considering COVID-19's impact on their continuous disclosure requirements[1]. The CSA representative also commented that financial statement preparers should make sufficient and entity specific disclosure about the judgements made and assumptions used when preparing their financial statements. To the extent that the issuer has concluded no impairment indicators exist, the CSA will consider the issuer's continuous disclosure record holistically to determine what effect COVID-19 was expected to have on the issuer's industry and the appropriateness of the issuer's conclusion. Some Group members highlighted the need to include in the condensed interim financial statements relevant disclosures explaining significant changes in the entity's financial position and performance since the end of the last annual reporting period. For example, during an interim period, there could be an indicator that an entity's assets are impaired requiring management to test them for recoverability. Therefore, management should consider the IAS 1 *Presentation of Financial Statements* disclosure requirements related to estimation uncertainty and the specific IAS 36 disclosure requirements related to impairment assessments when determining what information to disclose about key assumptions, estimates, and sensitivity analysis in its interim financial statements. A CSA representative reminded the Group that consideration of annual disclosure requirements in relevant IFRS standards will also be an important starting point when deciding the extent of disclosure needed for other areas impacted by COVID-19 that are initially reported in an interim period.

[1] CSA/CSVM, "COVID-19: Continuous Disclosure Obligations and Considerations for Issuers," PowerPoint presentation, CSA website, March 6, 2020. https://www.securities-administrators.ca/uploadedFiles/General/pdfs/COVID-19_Continuous_Disclosure_Obligations_and_Considerations_for_Issuers.pdf

Issue 2: How does COVID-19 impact an entity's expected credit loss model applied to corporate trade receivables?

Analysis

The measurement of expected credit losses should reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes, and the time value of money. Entities should exercise judgment and best efforts to consider all reasonable and supportable information available about past events, current conditions and forecasts of future economic conditions.

Entities using the simplified approach under *IFRS 9 Financial Instruments* to estimate lifetime expected credit losses often use provisioning matrices that are based primarily on historical collection data. Due to the impacts of COVID-19 on various industries and the economy as a whole, entities should consider adjusting the provisioning matrices to incorporate reasonable and supportable information that is available at the reporting date. These adjustments will need to reflect specific facts and circumstances and incorporate the judgments made about the pandemic's impact on a customer's industry and creditworthiness over the lifetime of the trade receivable.

Judgment may be required to apply post-model overlay assumptions that are directionally consistent with the changes in credit risk and the economic environment in measuring expected credit losses.

Previous assumptions used in the provisioning matrices regarding grouping and segmenting of counterparties with similar credit risk characteristics may no longer be appropriate as different entities may be more affected than others because of COVID-19. As such, these groupings may need to be revisited.

Entities should also disclose the key assumptions used, and judgments made in estimating the expected credit losses.

The Group's discussion

Group members agreed with the analysis, observing that due to the uncertainty from COVID-19, the assumptions about future economic conditions have become a more significant part in estimating the expected credit losses.

One Group member considered the ongoing relief programs provided by the Canadian government and noted that for the financial reporting period, entities should disclose the judgements made to distinguish the information that was known at the reporting date and used to measure the ECL from that arising in the subsequent period. In addition, for non-adjusting events, this Group member noted that entities should follow the requirements in paragraph 21 of IAS 10 to disclose the nature of the event and the estimate of its financial effect on an entity's financial statements.

A few Group members commented that customers' specific conditions must be factored into the adjustments to ECL estimates. Some Group members noted that a temporary payment relief granted to a customer is not an automatic trigger for significant increase in credit risk requiring a movement from Stage 1 to Stage 2 under the general impairment model. These Group members observed that when a model is used to estimate the ECL based on historical inputs, management should incorporate COVID-19 related factors to reflect post-model overlay assumptions in the adjustments to ECL. Some examples of these assumptions include the industry, the sector and the geographical location in which a customer operates, and the effect of government support. Another Group member observed that the impact of COVID-19 to different entities can be drastically different with some entities benefiting from the business opportunities created by the pandemic.

Fact Pattern for Issue 3

As a result of government-imposed closures due to the pandemic, many businesses have sent employees home with pay. These employees are inactive while at home but are expected to return to work whenever operations resume.

Issue 3: How should an entity account for employee costs when employees are inactive because of COVID-19?

View 3A – Salaries and wages should be accrued and expensed at the point in time that the employee becomes inactive.

Paragraphs 13(b) and 18 of IAS 19 *Employee benefits* state that when recognizing non-accumulating paid absences "an entity recognizes no liability or expense until the time of the absence, because employee service does not increase the amount of the benefit." The triggering event is the point in time at which the employee stops providing services. At such point, the employer would estimate, accrue, and expense the amount to be paid to the employee over the course of the absence. If the amount is uncertain, an estimate should be made and subsequently updated as new information becomes available.

View 3B – Salaries and wages of the inactive employees should be accrued and expensed over time.

Under this view, wages and salaries are paid to employees to stay at home, partially to ensure a smooth transition when business returns to normal. As a result, the inactive employees are providing benefits to the employer throughout the period of inactivity.

In addition, the time of absence is continuously re-evaluated rather than fixed at the date the employee becomes inactive. Therefore, proponents of this view refer to the non-accumulating paid absences guidance in paragraphs 13(b) and 18 of IAS 19 and think that the salary continuation costs are expensed as incurred. This is consistent with the expectation that the employees will return to work when called upon to do so.

Entities should assess their own specific facts and circumstances in making the determination of how to account for such arrangements in accordance with IAS 19. There may be specific clauses within employment contracts that deal with this type of situation. Further, the plan or period of time where employees are inactive may be communicated broadly, which may create a constructive obligation.

The Group's discussion

Group members supported View 3B. Some Group members noted that the employees are not terminated. Instead, these employees are standing ready to return to work during this inactive period to ensure a smooth transition when business normalizes. Therefore, the employees' salary and wages should be accrued and expensed over time. A few Group members further highlighted some complex scenarios in practice that make it difficult to accrue and expense salaries and wages at a point in time. For example, some entities may give their employees full-time pay while the employees work reduced hours. Other entities may reduce salaries for all employees during the inactive time but reimburse the employees when business returns to normal.

Fact Pattern for Issue 4

- The Government of Canada has announced various programs to assist individuals and businesses affected by COVID-19. An example is the Canada Emergency Wage Subsidy (CEWS).
- The CEWS was announced by the Government of Canada on March 27, with further details announced on March 30, April 1 and April 8, 2020. On April 11, legislation was passed, providing more definitive clarity on the CEWS. Subject to limited exceptions, employers of all sizes and across all sectors of the economy are eligible for the CEWS, provided their revenues have decreased by 15% or more for March and 30% or more for April and May. The subsidy is calculated based on a formula that generally covers 75% of an employee's wages, to a maximum of $847 per week, retroactive from March 15, 2020.[2]

Issue 4: How does an entity account for the CEWS received, or expected to be received, as a result from COVID-19?

Analysis

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* applies to government grants. However, not all programs introduced by governments qualify as government grants in accordance with IAS 20. Paragraph 2 of IAS 20 states that the standard does not deal with:

(a) the special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature.

(b) government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability. Examples of such benefits are income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates.

(c) government participation in the ownership of the entity.

(d) government grants covered by IAS 41 *Agriculture*.

In considering if the CEWS is a government grant, or if another IFRS Standard applies, an entity needs to determine who the subsidy benefits. If the subsidy benefits solely the employee, it may be viewed that the employer acts only as an agent of the government in disbursing the subsidy, and therefore, IAS 20 would not apply.

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[2] On May 15, 2020, the Government of Canada announced that it would be extending the CEWS by an additional 12 weeks, extending eligibility, and consulting with key stakeholders on potential adjustments to the program.

Payments made under the CEWS are designed to benefit the employer, and therefore, IAS 20 should be applied. The employer receives compensation to enable retaining its trained workforce and recommencing operations when possible. An employer is still incurring costs but can recoup an eligible amount from the subsidy program if certain revenue reduction criteria are met.

Under IAS 20, a government grant is only recognized if there is reasonable assurance that the entity will comply with the applicable conditions, and that the grant will be received.

For entities with financial reporting periods ending March 31, 2020, assessing when to recognize the government grant may be challenging. Although certain details of the subsidy were announced prior to March 31, and the subsidy is retroactive to March 15, details were not fully established until legislation was enacted on April 11. As a result, it would be difficult for an entity to establish that it qualifies for the CEWS as of March 31.

For entities with financial reporting periods ending after March 31, 2020, they will need to assess their compliance with the revenue reduction criteria as set out by the Government of Canada. If an entity can demonstrate eligibility, the grant should be recognized when the qualifying employee expense is incurred. Grant income should be presented either separately as other income or deducted from the related employee expense.

If the related employee expense is capitalized to an asset, the grant should be recognized and presented as deferred income or as a reduction from the carrying amount of the asset. The grant is then recognized into income on a systematic basis over the life of the asset.

The Group's discussion

Group members agreed with the above analysis.

Some Group members provided practical insights into assessing the conditions to recognize government grants when applying paragraph 7 of IAS 20 to various government programs. One Group member commented that currently, many questions on the administration of the relief program remain unanswered by the government. Questions such as who is eligible for the relief program and how the various relief programs interact with each other may create uncertainties in determining whether an entity has met the grant conditions. Therefore, even though the legislation has passed for these relief programs, an entity may not be able to meet the conditions to recognize a grant until a later time. Another Group member noted that receiving the grant may not be conclusive evidence that the grant conditions have been met. Some entities may have to repay the grant in the future if they did not meet the grant conditions. This Group member also observed that for some international grants, a government's ability to provide funding may create uncertainties in determining whether the entity is reasonably assured to receive the grant if the funding is provided on a "first-come first-served" basis.

One Group member thought that there are other factors to consider in addition to who the subsidy benefits when determining whether the entity is acting as an agent of the government or not. For example, an entity should consider which party bears the responsibility to meet the grant conditions and which party would have to repay the grant and pay any penalties if the grant conditions are not met.

Fact Pattern for Issue 5

- Entity A is a manufacturer with long term contracts with customers for its products. Revenue for these contracts are recognized over time in accordance with IFRS 15 *Revenue from Contracts with Customers*.
- As a result of COVID-19, Entity A has closed its manufacturing facilities. Entity A expects that it may not be able to meet the contractual delivery deadline for the products to its customers and may have to pay penalties.
- Historically, Entity A has not estimated any payment of penalties in accounting for its long-term contracts.

Issue 5: How does COVID-19 impact the recognition of revenue?

Analysis

COVID-19 could affect an entity's revenue contracts in multiple ways. One issue to consider is the impact on the estimation of variable consideration. Variable consideration might include discounts, refunds, price concessions, performance bonuses and penalties. The amount of variable consideration an entity includes in the transaction price is constrained to the amount for which it is highly probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainties related to the variability are resolved.

In the fact pattern noted above, Entity A may need to reassess the need to account for variable consideration. This assessment will be based on its estimates and judgments about the ability to meet the contractual delivery deadline, including expected periods of closure and time to resume its manufacturing processes. Such assessment will also need to take into consideration all contractual features of the arrangement between Entity A and its customer.

Certain contracts may also contain force majeure clauses and, therefore, such clauses should be analyzed to determine if they might apply to the COVID-19 pandemic.

Other issues that an entity may need to consider include, but are not limited to, the following:

- Assessing whether the impact of COVID-19 may give rise to onerous contracts, which should be accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- Determining whether a contract has been modified in response to COVID-19. If both parties agree to amend the scope or price (or both) of a contract, the entity should account for the modification in accordance with paragraphs 18-21 of IFRS 15.
- Considering any changes to timing of when the performance obligations in the contract can be fulfilled, which would affect when the related revenue can be recognized.
- Reassess whether it is probable that the entity will collect the consideration to which it is entitled. Significant judgement is required to determine when an expected partial payment indicates that: (1) there is an implied price concession to be accounted for as variable consideration; (2) there is an impairment loss (to be accounted for in accordance with IFRS 9); or (3) the arrangement lacks sufficient substance to be considered a contract in accordance with IFRS 15.

- Updating disclosures for the effects of COVID-19 given IFRS 15 requires an entity to disclose information that allows users to understand the nature, amount, timing and uncertainty of cash flows arising from revenue.

The Group's discussion

The Group agreed with the above analysis.

Group members highlighted some challenges that an entity may encounter when assessing accounting implications arising from a contract modification and reassessing the collectability of payments from customers in this COVID-19 environment. One Group member commented that entities should consider whether a modification to contract terms may include a significant financing component in the contract that the entity should account for. A few Group members noted that entities need to evaluate the collectability of contract consideration as the result of the pandemic. Significant uncertainty in collection can cause the contract to fail the definition of a contract under IFRS 15 leading to a change in the accounting outcome. Another Group member commented that interpreting whether the force majeure provision is enforceable in the COVID-19 environment can be particularly challenging, considering different interpretations of this provision by legal professionals.

One Group member encouraged financial statement preparers to review various publications available from public accounting firms to be informed of the various effects COVID-19 can have on revenue recognition accounting.

Overall, the Group's discussion on Issues 1 to 5 raised awareness of the potential impact that COVID-19 may have on an entity's financial statements. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).