Financial Reporting Hot Topics 2020 year-end focus

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These uncertain times present great challenges and opportunities for different parts of a business. For financial reporting functions, the current environment stress-tests the robustness of various processes and presents an opportunity for differentiation.

In this *Financial Reporting Hot Topics* newsletter, we highlight some areas of focus in the run up to 2020 year-end financial reporting.

Before going into the more detailed financial reporting considerations, the fundamentals: we believe the better financial reporting functions differentiate themselves from others with the following three success ingredients. These are particularly relevant at this particular point in time.

Successful financial reporting function =

Clear view on the company's operations, prospects and viability

Clear front-line visibility over the evolving business in a rapidly changing world where new technologies, uncertainty and emerging threats abound.

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Robust and well-governed financial reporting process

A thorough process with robust internal and external oversight to ensure the faithful application of relevant standards on the basis of the best available information and well-reasoned and supported judgement.

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Clear and transparent communication practice

A heightened awareness of potential additional user needs for a clearer and better company-specific picture of which operating decisions, judgements and estimates made by the board had a significant impact on the company's performance.

A list of the key financial reporting considerations for year-end 2020 is provided below. There are presented as key questions that should be asked or considered by financial statement preparers, management and those charged with governance in assessing if relevant matters are addressed and if specific accounting or reporting processes are optimised.

The challenges facing financial reporting functions are immense. Those that can stand up to the test, however, will not merely survive but will thrive.

Key financial reporting considerations for 2020 year-ends

Visit also our 'IFRS News' site for further information on the financial reporting implications of the COVID-19 pandemic, including webinars, newsletters, web articles and a COVID-19 resource centre.

Going concern The decision that the financial statements should continue to be prepared on a going concern basis may now involve more judgement than usual. *[IAS/HKAS 1.25-26]*	**How challenging is the going concern assessment? Is the assessment based on updated and realistic assumptions?** Where the going concern assessment involves significant judgement and estimate: ▪ Have the budgets and forecasts been updated to incorporate the best available and supportable information available while reflecting sufficiently the uncertainties in the current economic environment? ▪ Is it necessary to extend the lookout period beyond the minimum (i.e., beyond 12 months from the reporting date)? For example, if your company needs to refinance a significant debt shortly beyond the minimum 12-month period and the prospects of obtaining this necessary financing is a critical part of the going concern assessment? ▪ Are any mitigating plans achievable and realistic? For example, what are the uncertainties around securing additional financing? ▪ Are the assumptions used in the going concern assessment consistent with the information in the liquidity risk disclosures? ▪ Are there sufficient disclosures about the assumptions underlying the judgement, and how those assumptions relate to other assumptions underpinning different aspects of the financial statements?
Impairment of non-financial assets Pervasive impairment indicators may exist. Likelihood of impairment may increase. *[IAS/HKAS 36.8-17]*	**Have uncertainties been adequately reflected in the impairment assessment?** Where an impairment test is performed: ▪ Have the significant assumptions used in cash flow forecasts been updated to reflect the current circumstances? Should multiple scenarios be adopted and the expected cash flow approach be applied? ▪ Have you considered whether some of the assumptions, such as budgeted sales, could be overly optimistic and therefore need to be adjusted to ensure they are reasonable and supportable? What is the range of factors considered? Is the selected benchmark appropriate? ▪ The recoverable amount is the higher of value in use (VIU) and fair value less costs of disposal (FVLCD). Has FVLCD been overlooked when determining the recoverable amount which could result in overstating impairment loss? ▪ Has the discount rate used in cash flow forecasts been updated to reflect the current interest rates and the changing risk environment? ▪ If the expected cash flow approach is used, does the discount rate exclude risks that have been reflected in the cash flows to avoid double counting?
Revenue recognition Contracts with customers may no longer be enforceable or collectability may be in doubt. *[IFRS/HKFRS 15.9-16]*	**Should revenue recognition be suspended for some contracts due to significant changes in circumstances?** ▪ If contracts with customers include force majeure or similar clauses, have you considered whether those clauses could be invoked as a result of the pandemic, such that the contracts would no longer be legally enforceable? ▪ Is it probable to collect the consideration from the customer? Has the front-line feedback been sufficiently captured in making the assessment? ▪ Does your company and customer remain committed to performing their respective obligations under the contract?

Historical revenue estimates may become less predictive if customer behaviour has changed. *[IFRS/HKFRS 15.50-59, 91-104, B14-B27, B39-B47]*	**Have the myriad considerations of revenue estimates been adequately updated to reflect current circumstances?** ▪ Have you adequately updated the estimates of variable consideration (e.g. goods returns, sales discount, bonus or penalty for meeting or failing the specified performance condition) to reflect the current environment and any structural changes in behaviour? ▪ Have other areas of estimates, including breakage, contract renewal, amortisation and impairment of contract costs and measure of performance progress been updated to reflect current circumstances?
Provisions A contract may become onerous if fulfilment costs rise (e.g. higher production costs or shipping costs). A contract may also become onerous if expected benefits become lower (e.g. falling sales prices). *[IAS/HKAS 37.66-69]*	**Could there be some loss-making contracts due to changes in circumstances?** ▪ Have all the potentially loss-making contracts been identified by considering any significant budget changes? ▪ Have projections of costs and benefits sufficiently reflected expectations and information available at the reporting date? ▪ Before recognising a provision for an onerous contract, have all the assets dedicated to the contract been tested for impairment?
Trade receivables There may be adverse changes to debtors' willingness and ability to repay. Evaluation could become more judgemental. *[IFRS/HKFRS 9.5.5.17-5.5.20, B5.5.28-B5.5.55]*	**Has the estimation of expected credit losses (ECLs) of trade receivables been adequately updated to reflect changing circumstances?** Where ECLs are measured: ▪ Have the historical loss rates used in the provision matrix been adjusted for current and forward-looking information? ▪ If ECLs are measured on a collective basis, is there any change in credit risk characteristics that will trigger a need for regrouping? ▪ Have credit risk disclosures been updated for any changes in credit risk management practices in response to current economic conditions e.g., extending payment terms for trade receivables?
Fair value measurements Greater estimation uncertainty and reduced market activity may necessitate revisions to assumptions and the use of more judgement. Changes to valuation techniques may now involve the use of more unobservable inputs. *[IFRS/HKFRS 13.2-3]*	**How robust is the process around fair value measurements? Have the measurements been appropriately determined and adequately disclosed?** Where an asset or a liability is measured at fair value: ▪ Has an external valuer been involved in assisting with the determination of the more material and subjective fair value measurements? ▪ Have the measurements adequately captured the assumptions that market participants would use and the market conditions at the measurement date? ▪ Have any potential transfers between levels of the fair value hierarchy been adequately considered and identified? For example, does any fair value need to be transferred to a lower level in light of reduced market activity and additional adjustments using other non-observable inputs? ▪ Does the use of unobservable inputs become significant to the fair value measurement, resulting in a transfer into Level 3 of the hierarchy? ▪ Have the disclosures been sufficiently updated and/or expanded to reflect any changes to valuation techniques and assumptions? For example, have additional disclosures been provided as a result of a transfer from Level 2 to Level 3?

Leases Rent concessions may be received/granted. The concessions could be in various forms (e.g. one-off rent reductions, rent waivers or payment deferrals). *[IFRS/HKFRS 16.44-46B]*	**Have rent concessions been accounted for appropriately, in the right period?** If you are a lessee: ▪ If the optional practical relief introduced by the IFRS/HKFRS 16 amendment is to be applied, have you checked whether all qualifying criteria have been met, in particular the criterion that any reduction in lease payments affects only payments originally due on or before 30 June 2021?* ▪ When applying the practical relief, have you considered whether the rent concession is conditional such that the benefits of the concession are recognised in profit or loss only when the condition is met? ▪ And if the practical relief is not used, o is the rent concession given under the original terms of the lease (which would not be a lease modification) or otherwise (a lease modification)? o when applying the lease modification accounting, have you remeasured the lease liability using a revised discount rate at the modification date? If you are a lessor: ▪ Is the rent concession granted under the original terms of the lease (which would not be a lease modification) or otherwise (a lease modification)? * Amendment to IFRS/HKFRS 16, *Leases – COVID-19-related Rent Concessions* – see Issue 2020-3 of our *Financial Reporting Hot Topics* newsletter for further details. Please note that, at the time of writing, the International Accounting Standards Board (IASB) is planning to extend the time limit from 30 June 2021 to 30 June 2022. If the time limit is to be extended, the amendment would be issued by the end of March and early application would be allowed. The HKICPA is expected to follow any decisions made by the IASB by issuing conforming amendment to HKFRS 16.
Government grants Significant government assistance in different forms may be received. *[IAS/HKAS 20.7, 12, 20, 29]*	**Have government grants been recognised in the right period? Have the grants been presented appropriately?** ▪ Are there any significant judgements around the 'reasonable assurance' recognition threshold? ▪ Has the nature of various forms of government grants been appropriately determined and recognised in the income statement in the right period? ▪ Has the presentation choice (gross vs net) been applied consistently to similar grants?
Disclosures There may be heightened user expectations for better information in particular around significant judgement and major estimation uncertainties. *[IAS/HKAS 1.122-133]*	**Have sufficient transparent disclosures about significant judgement and major estimation uncertainties been provided?** ▪ When identifying areas for which disclosure of significant judgement and estimation uncertainty is required, have you considered items which have raised particular concerns or discussions in the management, administrative or supervisory bodies, including the audit committee? ▪ Are the disclosures sufficiently granular so that users can understand what those judgement and estimation uncertainties are, the level of uncertainties and how they could impact different aspects of the financial statements? ▪ Have you considered whether information about the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculations will be warranted given the uncertain environment and their significance to financial statements?

Others	
	▪ Does someone in your company oversee the projections used for different assessments (e.g., going concern assessment, recoverability test of non-financial assets and onerous contract test) to ensure consistent assumptions are used? ▪ Does someone in your company review the information given throughout the annual report to ensure the disclosures in the financial statements are consistent with the other parts such as the business review in Management Discussion and Analysis? ▪ If your company presents non-GAAP performance measures in the annual report, have you considered whether the measures are consistent with the relevant regulatory guidance? See our article on non-GAAP measures for further details.

If you have any questions about the matters discussed in this publication, please feel free to contact the following partners or your KPMG contacts.

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