IFRS Today

Our series on the most topical issues in IFRS® Standards and financial reporting

16 April 2020

Reinhard Dotzlaw
KPMG's Global IFRS leader

Gabriela Kegalj
Partner, KPMG in Canada

Chris Spall
Partner, KPMG International

Brian O'Donovan
Partner, KPMG International

PODCAST TRANSCRIPT

COVID-19 – Financial reporting implications

Speakers

- Reinhard Dotzlaw
- Gabriela Kegalj
- Chris Spall
- Brian O'Donovan

Reinhard

Hello and welcome. I'm Reinhard Dotzlaw, a partner at KPMG in Canada and global IFRS leader, and in this podcast we've gathered some of our IFRS specialists to talk about the significant impact that COVID-19 is having on financial reporting.

With me today are Gabriela Kegalj, Chris Spall and Brian O'Donovan. Over the next 30 minutes, we'd like to share with you some of the biggest accounting and reporting issues we've heard about from our clients. Like many of you, we're working from home to help flatten the curve and so we've been collaborating remotely to produce this podcast.

In this podcast we plan to cover four broad topical areas:

1. the big picture, existential threats that the virus is having on the ability of a business to survive and what that means from a financial reporting perspective;
2. to the impacts that the volatility and uncertainty in our environment is having more generally from a recognition and measurement perspective on things like recoverability and valuation of assets;
3. with a discussion of some of the top frequently asked questions we've been fielding on individual IFRS® Standards;
4. with what all this implies in terms of how to approach the disclosures in your interim reports this year.

Let's start with the big picture perspective. Gabriela, can you tell us what's different about assessing the viability of an entity as a going concern in this environment?

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

COVID-19 poses existential threats on the ability of a business to survive, which in turn have significant financial reporting impacts – from going concern and liquidity to recoverability and valuation of assets.

Gabriela

Reinhard, I'm hearing a lot about going concern, and whether going concern disclosures will be common in 2020 reporting. It doesn't get much attention when companies are generating lots of cash, profits are good and economic conditions are favourable. But the impacts of COVID-19, with declining demand, falling sales, margin pressures, are putting some strain on companies that as recently as 31 December had no reason to doubt that they are a going concern, and that they are able to meet their obligations as they fall due in the foreseeable future, at least for the next 12 months.

But what may have been obvious at 31 December may be less so now, and companies will need to carefully consider their going concern assessment when preparing their accounts in the next reporting cycle.

And this will be difficult because of the uncertainty and volatility in the current business environment and markets in general. Companies may still be a going concern but the key question will be: are the impacts of COVID-19 creating uncertainties that may cast significant doubt on their ability to continue as a going concern? To answer that question, companies might find themselves in this continuous cycle of reviewing new information, reassessing future plans, and reforecasting. And those budgets for 2020 that were developed in 2019 may now be of limited relevance given the rapidly changing economic outlook. And significant revisions may be needed in order to support management's assessment.

And that's going to involve careful modelling. Not just of management's best guess, but also the worst case that is realistically possible, a severe but plausible scenario. And things to think about might be: How long will the downturn in demand last? Will it extend late in the year? If parts of the business are closed or will need to close, for how long? And to conserve cash will salaries and wages need to be cut, or employees furloughed? How much, and until when?

Reinhard

Gabriela, can you talk a little bit about how financing and covenants fit into the going concern assessment?

The key question will be: are the impacts of COVID-19 creating uncertainties that may cast significant doubt on their ability to continue as a going concern? And what's the worst-case scenario that is realistically possible?

Gabriela

Sure. Companies may need to think about not just their current financing arrangements with current lenders, but is there support from alternative sources – perhaps shareholders, perhaps even governments? And that could be tricky: government responses to the pandemic are continuously evolving. Some are legislating on the fly.

As for those covenants, after updating the forecasts, management will need to assess whether it expects to remain in compliance with financial covenants and this means carefully looking at borrowing facilities to understand all the terms and conditions. Will the company be in breach of these facilities because of a lack of liquidity? Or a covenant breach? If it's realistically possible, that's a material uncertainty. And disclosing this in the financial statements isn't saying it *will* happen, it's just saying it's plausible it *might* happen.

All this to say: the going concern assessment will not be easy, no-one has a crystal ball. The challenge is working out what is going to happen and when will we get back to normal. And this makes it more difficult to conclude that there are no plausible downsides which could put the company into financial difficulties.

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

Management really needs to be clear in its disclosures about its liquidity position, how COVID-19 is affecting that and how it is managing liquidity risk through the pandemic.

Reinhard

Gabriela, you mention that the going concern assessment won't be easy and no-one has a crystal ball. What does that imply in terms of disclosures?

Gabriela

Well when conditions are uncertain the need for clear disclosure is critical. And whether a company has a material uncertainty or not, investors and other stakeholders will want to know in a greater amount of detail what sort of scenarios the company has considered and how extreme are the downsides they have considered. If there is no material uncertainty a company will need to be clear on how resilient it is to downsides, and if there is a material uncertainty, management will also want to show how extreme were the downsides they considered that led to that conclusion.

Reinhard

Thanks Gabriela. OK, staying with this theme of going concern challenges, you mentioned that a key issue that many companies face in this uncertain environment is having sufficient liquidity to survive. Chris, can you talk a bit more about what you see the liquidity issues are that are resulting from this pandemic and that impact accounting and disclosure?

Chris

Yes Reinhard. As Gabriela said, liquidity management is a vital issue. Let's talk about that in general before going into some of the more specific questions.

I think the number one issue for most investors is going to be whether and how the company is going to survive the pandemic and come out the other side. Critical to that is liquidity. So whether or not you disclosed a material going concern uncertainty, management really needs to be clear in its disclosures about its liquidity position, how COVID-19 is affecting that and how it is managing liquidity risk through the pandemic. That's going to mean looking at updating and expanding disclosures about liquidity – especially compared to what might have been included in previous interim reports.

Let's list out some of the really important questions that companies need to be looking at answering in putting together their disclosures, like …

What are the company's liabilities? What cash or investments are held to cover them? What are the maturities of assets and liabilities? What are available borrowing facilities? Are they committed or uncommitted? Are they being drawn down today? Are providers of facilities actually able and willing to deliver on those commitments? Like Gabriela said, have you disclosed material covenants or other conditions that mean liabilities can be called or facilities pulled at short notice? Investors are going to be particularly interested in subjective clauses like material adverse change clauses or covenants or conditions that are dependent on things like credit ratings or financial metrics that could easily change adversely or other uncertain events. And don't forget factoring and reverse factoring arrangements: are you being fully transparent and explaining how COVID-19 impacts on them and how they can be utilised?

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

If you are thinking about getting some funding from the government. Key issues with this are going to be whether the funding is on market terms and what are the conditions you need to meet to get and to keep that assistance.

Reinhard

Thanks Chris. Now in addressing liquidity challenges, companies often are modifying debt agreements and may also be receiving government assistance. Chris, what are some of the accounting issues that you're seeing in those areas?

Chris

Yes these are quite hot topics at the moment.

So firstly, debt modifications. If – in order to manage liquidity – you're thinking about renegotiating the terms of borrowings, be aware there could be immediate big P&L impacts depending on the nature of the changes to the agreements and how the accounting standards apply to them. If it's considered to be what the standards call a substantial modification, you will have to remeasure the new debt at fair value and write off any deferred transaction costs you had. Even if the modification isn't considered what the standards call substantial, you still might have to remeasure the future cash flows with a big hit to P&L.

Next, government assistance. Maybe you are thinking about getting some funding or funding guarantees from the government or from government agencies. Key issues with this are going to be whether the funding is on market terms and what are the conditions you need to meet to get and to keep that assistance. Those points are really going to drive the accounting, including whether you need to apply special rules for accounting for government grants, and disclosures around government grants and government assistance. If you get assistance from government, then investors are going to expect clarity about that and they are going to want to know if there any strings attached to that assistance and what are any conditions about possible repayment.

Reinhard

Thanks Chris. Let's turn now to some of the more pervasive measurement challenges that we're seeing in this environment. Gabriela, what impact is COVID-19 having on testing the recoverability of assets?

Gabriela

Reinhard, this makes me think of impairment testing, especially for goodwill and other non-current assets like intangibles and PP&E. And at least two issues come to mind: triggers and cash flow forecasting.

So companies test goodwill annually, typically late in the fiscal year. Other assets are tested if there are indicators or triggers for impairment. So let's think about that. We've got rapid deterioration in the economic environment, increased uncertainty in business outlook, a sharp fall in stock markets accompanied by significant fluctuations in foreign exchange rates and commodity prices. And how this environment impacts each sector and each company individually will vary, perhaps significantly. The potential for a lot of triggers is there and companies will need to evaluate them carefully in light of their own circumstances if they need to do the test, even if those assets were tested at the end of 2019. At the risk of sounding repetitive, forecasts and budgets that may have been relevant for the December year end test may be less relevant now. Companies need to review, reassess and revise where necessary. And relying on the most recent impairment tests may not be appropriate.

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

How this environment impacts each company will vary. Companies need to evaluate the potential impairment triggers carefully in light of their own circumstances, even if those assets were tested at the end of 2019.

One of the revisions may be to the approach for forecasting cash flows. Companies may need to model multiple cash flow scenarios because it might not be possible to support a single most likely outcome scenario. Instead a range of reasonably possible outcomes may need to be presented and disclosed.

Because readers will want to know about the assumptions used in arriving at the ranges. Like gross margins, revenue growth rates and discount rates. And how sensitive those ranges are to changes in those assumptions. Some sectors of the economy are likely to be more pessimistic – for example transport, leisure or hotels – but management should be prepared to change everything as time evolves. Given a broader range of outcomes, the ranges should be agreed upon cross-functionally, with management and those charged with governance. And it's really critical that those ranges are used consistently across the business, for all estimates, such as the going concern assumption discussed earlier, and impairments.

Reinhard

Thanks Gabriela. As you said, estimating future cash flows certainly is challenging in this environment, impacting the things to think about when assessing the recoverability of non-financial assets. Chris, volatility and uncertainty has a direct impact on determining fair value. Can you talk us through some of the issues that's causing in terms of measurement of financial assets?

Chris

Yes Reinhard. When it comes to fair values the challenges really depend on the facts and circumstances. Let's first talk about the easy stuff and then move on to more difficult issues like inactive markets, uncertainty, credit losses and hedge accounting.

Measuring fair value is relatively straight forward when there's an active market. And there are lots of financial instruments and commodities where markets are functioning normally and where there is still great price transparency, even if the news those markets are delivering is not good news. For example, we can all see just how far and fast stock indices have fallen and that is driven by high trading volumes. So if you are valuing something for which there is a quoted price in an active market, you basically just need to take the closing market price. But it can start getting a lot more difficult when you don't have an active market.

For some financial instruments and many non-financial assets – like real estate – we've seen big declines in transaction volumes and markets drying up in some cases. That means measuring fair value can involve a lot more work and a lot more judgement. So as Gabriela said, maybe you need to change your valuation techniques for some items or think about new price sources. And if the prices are stale, or they relate to similar but different items, you need to think about how to adjust those prices, in particular for illiquidity and credit risk and increased uncertainty.

That brings us back to one of our key themes of uncertainty. Many valuation models are based on discounting future cash flows or on multiples of earnings streams. Coming up with reasonable judgements about these is going to be really tough. The economic fallout from COVID-19 is going to depend on how the pandemic develops and the nature and duration of restrictions on normal economic activities. Viewed in isolation, the declines in GDP might be seen as catastrophic but many governments have got out their big bazookas to try to mitigate the economic harm – and taking that into account could be critical. When you are looking at fair values, you are trying to get to a third party, independent market participant's perspective on value. That means trying to calibrate where you can to observable market data and building in the discount that a market participant would apply for bearing risk.

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

You can't just wait until a customer stops paying you before you book a loss. That means you need to be looking at how current and future economic conditions impact credit losses.

Market participants and investors are generally risk averse and now we are seeing an investment environment that is dominated more by fear than greed. So risk adjustments in valuation models are going to need some revisiting.

And much of that doesn't just apply to fair values, but also to what the standards call value in use, for measuring impairment for non-financial assets, like goodwill and intangibles.

Reinhard

Thanks Chris. What about some related recognition and measurement topics, such as credit losses and hedge accounting? What challenges are you seeing in these areas?

Chris

Yes, Reinhard. These are two areas which are causing my inbox to bulge. Firstly credit losses. Under a fairly recent new standard called IFRS 9, companies have to record today credit losses they expect to crystallise in the future. Again the uncertainty we face, makes that much harder to estimate. As Gabriela mentioned a key technique that companies use to address uncertainty in valuations is considering different plausible future scenarios based on what they know today and then estimating how likely each one is. This is a key technique that banks and other lending businesses use to measure expected credit losses and measuring credit losses is the biggest accounting challenge they're facing.

But don't think expected credit losses is just a problem for banks. If you are a corporate, you still need to be booking expected credit losses on your trade receivables and any loans or finance lease assets that you have. And the operative word to stress again is *expected*. You can't just wait until a customer stops paying you before you book a loss. That means you also need to be looking at how current and future economic conditions impact on amounts of credit losses. In my experience, the models corporates use for this give a very large weight to historical data and the inputs will need to be updated for COVID-19 conditions.

And last but not least, let's talk about hedge accounting. This is another area where declines in business activity and increased credit risk create real challenges. If you are hedging a future transaction and that transaction is no longer very likely to actually happen, then you will have to stop hedge accounting. And if the transaction is no longer even likely to occur, then you will need to take all the previous accumulated hedging gains and losses and move them into P&L today. This can happen because of reduced sales or purchase requirements. Credit risk increases can also lead to hedge accounting failures or increased P&L volatility because that credit risk reduces the effectiveness of the hedge relationship in economic terms.

And finally, remember if you have a loss from a cash flow hedge parked in equity, you will need to flush that loss into P&L if you don't think you will be able to recover that loss in the future. For example, say you are hedging a purchase of inventory, but you don't think you will be able to sell that inventory at a profit in the future that covers the hedging losses: you will have to book the hedging losses in P&L today. I think that COVID-19 is really going to mean that management will have to look at lot more closely at these issues.

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

The new lease assets and new lease liabilities that came on balance sheet in December 2019 could look very different today.

Reinhard

Thanks Chris. OK, we've talked about the big picture existential threats caused by COVID-19 such as going concern and liquidity, then we moved on to talk about how uncertainty and volatility is impacting issues such as recoverability of assets, determining fair values and hedge accounting. Now let's talk through some of the detailed questions we're seeing on individual IFRS Standards. Brian – you've been telling me that you're fielding lots of questions on some very familiar topics – like leases, revenue and provisions. Can you tell us about some of the new issues you're seeing in these familiar areas?

Brian

Yes Reinhard. Happy to.

Perhaps if I start with leases. Now my heart really goes out to everyone who worked so hard to implement the new leases standard last year. However, I fear that the new lease assets and new lease liabilities that came on balance sheet in December 2019, well, they could already look very different today.

Now there are several reasons for that. The first is impairment. The new lease assets – what the standard calls right-of-use assets – they're subject to impairment in just the same way as PP&E. So everything Gabriela said about impairment applies equally to leases that are now on balance sheet.

But don't forget about that old onerous contract test for leases. Perhaps quite legitimately you kept some of your smaller leases off balance sheet – short term leases or leases of low value items. Those leases could still be onerous. Suppose you leased 20,000 laptops for your employees to use but only 10,000 of those employees are still active in the business. Could some of those laptop leases now be onerous?

The second reason is that the amount of the lease assets and the lease liabilities on balance sheet is very sensitive to the way you think about options in your lease contracts – renewal options, purchase options. The leases standard has a very specific approach to options: you account for them essentially if you are reasonably certain to exercise them. My goodness, I'm not reasonably certain of anything right now. If recent events have changed the economic incentives around these options, if you're taking new decisions about how to use your leased assets in the business, then that could drive big remeasurements now.

All of this assumes you are sticking by the lease agreements that you signed on day one. What I'm hearing is that lots and lots of people are actually making changes to their lease agreements. That could be as simple as reducing rent for a few months, or it could be a broader renegotiation of the terms and conditions of the lease contract. This is the third reason your lease balances could look different today.

Now the good news is that the standard tells you in quite a lot of detail exactly what to do if you have what it calls a lease modification. The bad news is you might not like what it tells you to do. Suppose I'm a tenant in a real estate lease and I've changed my lease. Well I don't necessarily take the benefit of that change to P&L straight away. Instead I have to recalculate my lease assets and lease liabilities, and I have to do that using a revised discount rate. Now this is a very hot topic: it's one that the IASB is looking at right now. They have just published educational material on rent concessions, and they also plan to debate whether to make changes to the leases standard itself to provide relief specifically in this area.

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

We sometimes say in revenue accounting that even fixed consideration can be variable. If you are offering concessions to your customers … that could have a dramatic impact on your revenue recognition.

To move on from leases to revenue, then everything becomes very, very immediate. By definition, revenue is about what's happening right now in your operating cycle. There is a special impairment test that only applies to your revenue contracts – particularly if you are carrying forward in your balance sheet the costs of acquiring customer contracts or other costs associated with fulfilling those contracts – it's a specific test, in the revenue standard, and often it's driven by your expectations as to whether or not customers will renew their contracts. So maybe some businesses will be carrying forward quite big costs in an expectation of a high level of customer renewals. If you can no longer justify that expectation then perhaps those costs could be subject to impairment very, very quickly.

In terms of the revenue accounting, revenue recognition these days is all about accounting for the contract with the customer. It's about the enforceable rights and obligations in those contracts. Now perhaps the contracts you thought you could enforce a few months ago are no longer enforceable, or perhaps individual terms within those contracts aren't enforceable. Perhaps you yourself are choosing not to enforce, perhaps the courts are not standing by you if something goes to court, or perhaps governments are providing relief that is effectively a form of protection for your customer. If you can't enforce your contract, you might have to stop recognising revenue at all. And if you get over contract enforceability you really have to look at whether the amounts your customers are going to pay are the amounts you expected them to pay in the first place. We sometimes say in revenue accounting that even fixed consideration can be variable. If you are offering concessions to your customers to keep them engaged, that could have a dramatic impact on your revenue recognition.

Reinhard

Thanks Brian. Now let's talk a little bit about liabilities. I can imagine that there are some familiar topics but some new emphasis that the virus is causing in that area.

Brian

That's a great point, Reinhard. I think the big issue – and it can be very, very sensitive – is all about restructuring. I think management of lots of companies are looking and making really painful decisions about whether the business can continue in its current form, whether everyone's colleagues will continue to be employed.

This is very difficult A business might have got to the point where it knows it has to restructure but it might not have settled on a detailed restructuring plan. So perhaps it feels like you should have a liability in the balance sheet for your restructuring costs. But remember provisions accounting under IFRS [Standards] is not a big bath approach – you have a provision for a restructuring plan only when that plan is pretty detailed and either you've begun to implement it or have at least communicated it to the people who are going to be affected.

Reinhard

Thanks Brian. OK Gabriela, can you wrap it up for us – given the uncertain environment we are experiencing, how do you recommend CFOs and controllers approach disclosures this year in their interim reports?

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

One thing is certain: companies must stand ready to update their financial information, probably more so than usual, for 2020 interims.

Gabriela

Reinhard, if I could play one word on repeat here it would be update, update, update.

And while the present circumstances carry with them uncertainty about the future, one thing is certain: companies must stand ready to update their financial information, probably more so than usual, for 2020 interims.

Post 31 December, and post any interim reporting date, you can't put down your pen and paper. There is a constant flow of news that companies should monitor for its potential impact on the accounts and I want to highlight this in terms of three areas: subsequent events, estimation uncertainty, and interim disclosures in general.

Companies need to separately assess the events that have occurred as a series of unfolding events related to COVID-19. This includes events and conditions that are new, and didn't exist at the balance sheet date, versus those that provide more information or shed more light on conditions existing at the balance sheet date. New events are not adjusted for, but those that shed more light are, and deciphering between the two could require judgement.

Now monitoring the flow of news isn't just for subsequent events. Companies make judgements and assumptions throughout the financial statement preparation process. And these are often prone to estimation uncertainty at the best of times. We've discussed some typical areas: the going concern assessment and forecasting covenant compliance, impairment reviews when forecasting recoverability of assets, and fair value measurements when market prices might not be readily observable. Any time there is financial uncertainty, the need for clear and transparent disclosure on estimation uncertainty increases, updated where necessary in the interims, to help users understand the challenges in preparing the financial statements.

And, Reinhard, I often get asked where does IAS 34, the interim reporting standard, require disclosure about a specific transaction or an event? It's true, IAS 34 isn't as prescriptive as to what exactly requires disclosure, it rests on a principle of updating the most recent annual financial statements with relevant information that is significant to understanding the company's results and position and cash flows in the interims. And in the light of the rapidly changing environment, more information than usual may be needed when providing an update to readers. Indeed investors, lenders and regulators, may be expecting it.

Reinhard

Thank you everyone for your insights.

These certainly are challenging times for businesses, with lots of uncertainty and constant change. In this podcast, we've highlighted some of the biggest accounting and reporting issues we think you'll face in preparing your interim reports this year. But we've been barely able to scratch the surface. To find our latest thinking and guidance on the potentially significant accounting and disclosure implications for your company, and the actions you can take now, just type **KPMG IFRS** into your browser. You'll find our **COVID-19 financial reporting resource centre** featured on that web page.

Thank you very much for joining us. Please take care and stay safe!

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

Publication name: *IFRS Today: COVID-19 – Financial reporting implications*

Publication date: April 2020

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

KPMG International Standards Group is part of KPMG IFRG Limited.

KPMG International Cooperative ('KPMG International') is a Swiss entity that serves as a coordinating entity for a network of independent firms operating under the KPMG name. KPMG International provides no audit or other client services. Such services are provided solely by member firms of KPMG International (including sublicensees and subsidiaries) in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any other member firm, nor does KPMG International have any such authority to obligate or bind KPMG International or any other member firm, nor does KPMG International have any such authority to obligate or bind any member firm, in any manner whatsoever.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

This publication contains copyright © material and trademarks of the IFRS® Foundation. All rights reserved. Reproduced by KPMG IFRG Limited with the permission of the IFRS Foundation. Reproduction and use rights are strictly limited. For more information about the IFRS Foundation and rights to use its material please visit www.ifrs.org

Disclaimer: To the extent permitted by applicable law the Board and the IFRS Foundation expressly disclaims all liability howsoever arising from this publication or any translation thereof whether in contract, tort or otherwise (including, but not limited to, liability for any negligent act or omission) to any person in respect of any claims or losses of any nature including direct, indirect, incidental or consequential loss, punitive damages, penalties or costs.

Information contained in this publication does not constitute advice and should not be substituted for the services of an appropriately qualified professional.

'IFRS®', 'IAS®', 'IFRIC®' and 'IASB®' are registered Trade Marks of the IFRS Foundation and are used by KPMG IFRG Limited under licence subject to the terms and conditions contained therein. Please contact the IFRS Foundation for details of countries where its Trade Marks are in use and/or have been registered.

home.kpmg/ifrs