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IFRS Today

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

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EPISODE TRANSCRIPT

COVID-19 – Accounting for provisions

Speakers

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Ian

Hi everyone, I'm Ian Greenwood, a director in KPMG's Accounting Advisory practice in London – and at the moment I'm spending a lot of my time supporting clients with COVID-19-related accounting questions.

Irina

And I'm Irina Ipatova from KPMG's International Standards Group. Similar to you, Ian, we're busy with COVID-19 questions from all over the world, and in most of them we are talking about provisions under IAS 37 [*Provisions, Contingent Liabilities and Contingent Assets*].

Ian

And that's not a surprise because investors are expecting to hear bad news. So companies want to ensure they have captured all of the costs now.

Irina

Agreed, but you need to get the balance right – between under- and over-providing.

The key point is that under IFRS Standards you cannot provide for future operating losses.

You *cannot* provide for future operating losses but *should* provide for a loss-making contract.

Ian

So Irina, I think it would be good to compare notes on the advice we are giving and share this with our listeners. And there's three key areas we're getting questions about:

- The first of which is extra costs – so there's a lot of costs associated with COVID-19 – and should all of these be recognised now?
- The second area is committed costs – so what if I no longer expect to recover these costs fully?
- And third, restructuring provisions – it's a tricky area, and when is the right time to recognise a restructuring provision?

Irina

Very good idea, Ian! We get a lot of similar questions from different countries.

Ian

Okay, so – on the extra costs point.

One of my clients is in the construction sector. They've got long-term construction contracts that they account for on a percentage of completion basis, and they're having lots of challenges around the impacts of COVID-19 on these contracts.

So they're really keen to recognise the impact of COVID-19 in the P&L now, as opposed to having an impact on their longer-term margins. And in particular management don't want to be referring to COVID-19 when explaining their results for years to come.

Irina

This is not surprising! We hear similar concerns from many countries across the world.

Ian

So, at the beginning of lockdown, this client closed down construction sites and they incurred a lot of cost. It was decided that these costs weren't contributing to the progress on the contract, so were taken to P&L immediately.

Now they're going to incur a lot of cost in the future, too – so they've got to re-open the sites, and particularly because they've got to operate under social distancing. So they might be working a lot less efficiently going forward.

And they want to provide for these costs so that the impact of coronavirus is recognised now when their investors are expecting it.

We have been advising them that this is a challenging area that requires a lot of consideration – and that some of the related costs may need to be recognised in the future.

Irina

I agree, Ian. You *cannot* provide for future operating losses but *should* provide for a loss-making contract.

Companies are finding it really challenging to draw the line between costs directly relating to a specific project compared to those costs of running the business.

Ian

Yes that's true, and companies are finding it really challenging to draw the line between costs directly relating to a specific project compared to those costs of running the business.

Irina

Okay, let's take your example. If the construction company estimates that the purchase price of materials will go up and it would take (let's say) up to six months longer to complete the project, then these are likely to be the costs directly related to the specific construction contract.

You need to consider these costs when determining if a contract has become loss-making. If it has, then the company would create a provision – so ultimately recognising the COVID-19 costs now.

On the other hand, if to comply with the regulations your client needs to fit new plastic screens in the office in the future, then these are likely to be future operating costs. These future operating costs will be recognised only when they are incurred – they cannot be provided for now.

Ian

Great – that's a good point! So what we're doing with clients is we're carefully reviewing all the COVID-related costs now and we're determining whether they are future operating costs or something that needs to be provided for.

Irina

I agree. The other extra COVID cost we hear about is penalties. For example, a late delivery penalty.

We advise to consider if the contract contains a force majeure clause and if COVID-19 is regarded as the force majeure in the jurisdiction.

If so, you may not need to pay any penalties. It's better check to with your lawyers!

But if you are subject to a penalty, then I'm afraid that you cannot provide for an anticipated future breach. And to recognise a provision, there needs to be what's called an 'obligating event' and a 'present obligation' – this is unlikely to happen before you breach the contract.

Ian

I agree – and this is also the case if they decide to terminate the contract. They need to consider if there is a present obligation that can't be avoided.

If a contract is determined to be loss-making, then the costs to terminate it may be recognised earlier.

Irina

You know what? One difference though: costs of terminating a contract are part of the test if the contract is loss-making. So if a contract is determined to be loss-making, then the costs to terminate it may be recognised earlier.

Ian

So Irina, it sounds like we are on the same page on extra costs – we need to determine the nature of these costs and we do not provide for future operating losses.

Irina

Yes, and make sure to identify the right obligating event.

Ian

So if I move from these extra costs and on to our committed costs, I've got one particular example: we've got a brewery and they're committed to buying hops; however they've had to stop production as – unfortunately for all of us – the pubs are closed.

Irina

Yes, that is very unfortunate [laughs]…

Ian

So some might argue that they need to provide for this contract as they're not going to be able to use the hops that they're committed to buying. But I don't think it's that simple. They need to decide if they're going to make a loss on the related sales contracts or if it's just a case of a reduced margin.

Irina

You know what? They could also think about whether they can terminate or renegotiate the existing supply contract. I have to say, in the current circumstances, this may be feasible even if the contract was originally non-cancellable.

Ian

Okay, so if they can't avoid buying the hops, they'll need to consider if there is anything else they can do with them, like sell them, or if they are going to actually make a loss on these.

You don't provide for staff costs in advance just because you furloughed them and received government assistance.

Irina

Yes – they can recognise a provision *only* if there is a loss-making contract.

We are getting a lot of similar questions and keep reminding people that in assessing whether it is a loss-making contract, they will need to compare the expected benefits under the contract with the unavoidable costs of meeting the obligation. And the unavoidable cost of meeting the obligation is the lower of costs to fulfil the contract and the cost to terminate it.

Ian

Okay, sounds like we've got another common theme there!

Irina

Absolutely. I have another example of committed costs, which is different to hops.

Many companies across the world have committed to furlough staff and are receiving government assistance.

We all know that staff are going to be off for the next three months, and not working. But this is different to the hops. You don't provide for staff costs in advance just because you furloughed them and received government assistance.

Ian

Yes, we've dealt with this issue quite a bit as well, and you would account for the committed staff costs as usual – so you'd recognise an expense in the period in which the staff were supposed to provide their service.

And if you receive a government grant, then the related income will be recognised in the same period as the expense that the grant is compensating for.

Irina

Agreed. The last one to mention on the committed costs is the rent. These days, many ask if they should consider providing for an onerous lease.

Ian

Same here. One of my favourite topics! And we keep reminding clients that under the new lease requirements in IFRS 16 [*Leases*] you can no longer have an onerous lease provision. Instead you need to review the right-of-use asset for impairment.

Irina

Absolutely – and you cannot create a provision for any lease-related costs that were excluded from measurement of the lease liability (and the right-of-use asset) under IFRS 16.

Restructuring is a challenging matter. You recognise a provision only when specific conditions are met.

Ian

Great to hear that we're getting consistent messages on these committed costs.

And the last thing I wanted to cover was restructuring provisions.

As a result of COVID-19 I've got a retail client and they're looking at restructuring the business. So they're considering not re-opening some of their stores, and at the same time making some of their staff redundant.

So just like the construction company, they're also really keen to book all of the COVID-related impacts in this half year, and present all of the bad-news now so that they don't have longer-term impacts.

Irina

And they're not alone – we hear that a lot of companies in different parts of the world would want to do the same. But, restructuring is a challenging matter. You recognise a provision only when specific conditions are met.

Ian

Yes! And first, you need to have a detailed formal plan for the restructuring, and then second, you need to raise valid expectations that you're going to implement that plan.

Irina

And I'd normally expect the company to say which stores will be closed, and maybe the approximate number of employees they plan to make redundant.

Ian

I agree. And if at this stage the plan was just approved by the company's board but they hadn't taken any further steps, then that wouldn't be sufficient to recognise a restructuring provision.

Irina

Looks like we are on the same page on restructuring too!

Ian

Great – let's boil this down to three key takeaways for our listeners.

– The first one being: you cannot provide for future operating losses. So you can't reflect all your COVID-19 costs now. And a hit to margins is just something you can't provide for.

– Two: the onerous contract assessment may be challenging in some cases because it may be difficult to determine which costs relate directly to the contract.

– And three: you cannot recognise a restructuring provision unless specific criteria are met.

Don't forget meaningful and transparent disclosures in the financial statements about uncertainties, judgements and estimates made. These are key to ensure your efficient communication with stakeholders.

Irina

I fully agree, Ian. And don't forget meaningful and transparent disclosures in the financial statements about uncertainties, judgements and estimates made. These are key to ensure your efficient communication with stakeholders.

Ian

Okay! Well thank you Irina, and thank you everyone for listening.

If you want to learn more about accounting for the impact of COVID-19, type 'KPMG IFRS' into your browser and you'll be taken to KPMG's **COVID-19 financial reporting resource centre**.

Irina

That centre has more information on the accounting for provisions but of course this isn't the only topic that we've been dealing with. There are many other COVID-19 related accounting issues and that page has lots of detailed information on all of those other issues as well.

Thank you – and stay well.

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