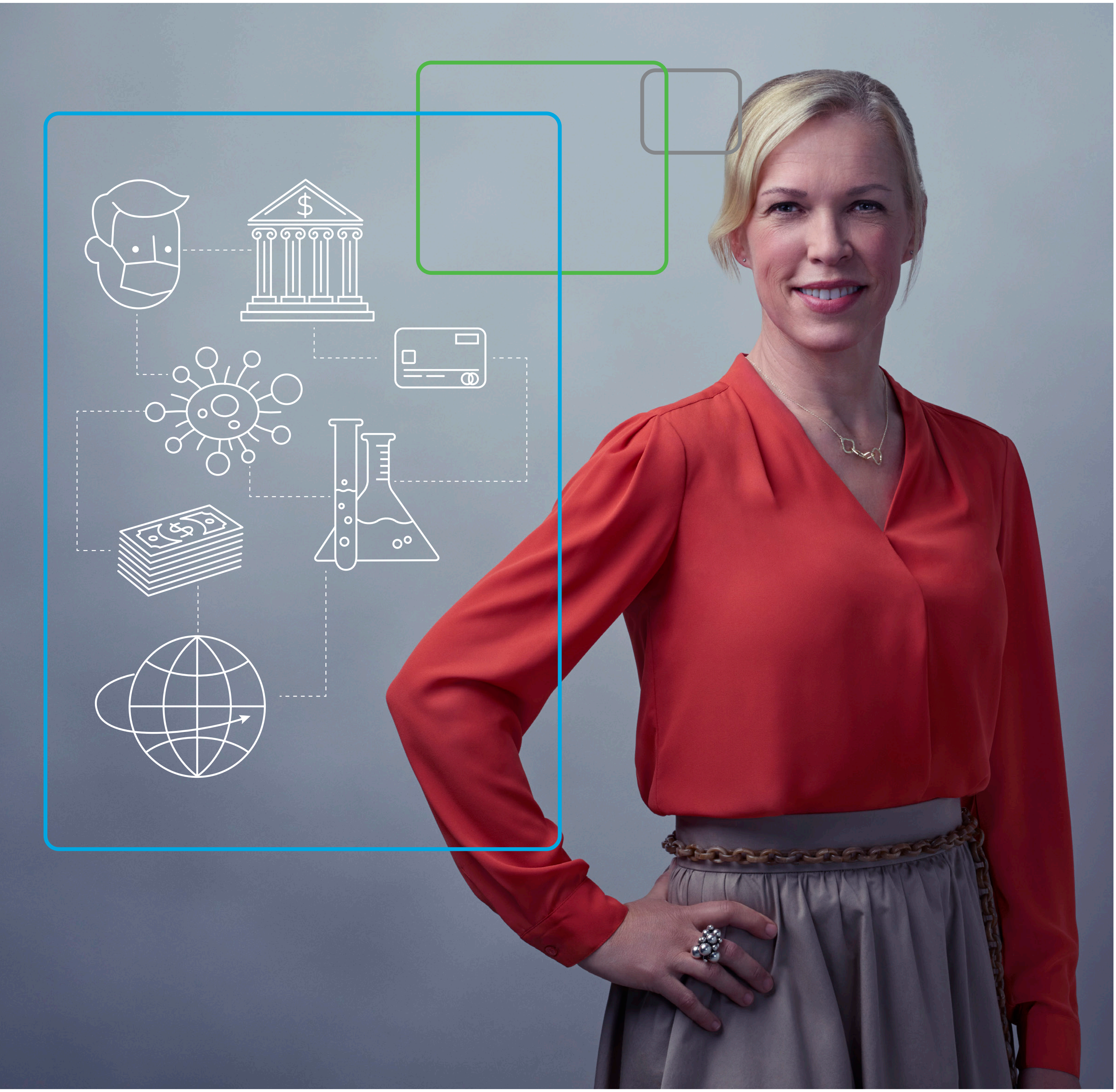

COVID–19: IFRS FINANCIAL REPORTING IMPLICATIONS

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The effects of COVID-19 are evolving rapidly and are unique for each entity's circumstances. In addition to addressing the serious operational impacts of the coronavirus, it is important that all entities consider how COVID-19 affects their financial reporting. We offer the following high-level overview of a few matters for consideration during this critical time.

FINANCIAL REPORTING CONSIDERATIONS – DECEMBER 31, 2019 YEAR-END FINANCIAL STATEMENTS

Subsequent events

Under International Accounting Standard (IAS) 10, Events After the Reporting Period, events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorized for issue. Two types of events can be identified:

a. Those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and
b. Those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

IAS 10 requires entities to adjust the amounts recognized in their financial statements to reflect adjusting events after the reporting period, and entities do not adjust the amounts recognized in financial statements to reflect non-adjusting events after the reporting period. In making this determination, entities must exercise judgement and carefully consider their individual facts and circumstances.

The significant deterioration in economic conditions associated with COVID-19 is generally viewed to have begun in the first quarter of 2020. Therefore, a calendar-year-end entity that has not yet finalized its 2019 financial statements needs to assess the estimated impact of COVID-19 and the related economic impacts on its business, as an adjusting or non-adjusting subsequent event. For non-adjusting events, entities (affected directly and indirectly) should consider disclosing the nature of the event and an estimate of the impact on the financial statements if known and quantifiable, or a statement that an estimate cannot be made.

Going concern

COVID-19 may have a significant impact on an entity's operations. Going concern considerations are made differently than those related to "non-adjusting subsequent events". Deterioration in current or future operating results and financial position after December 31, 2019 may indicate a need to consider whether the going concern assumption is still appropriate or whether material uncertainties cast significant doubt on the entity's ability to continue as a going concern.

Entities that expect COVID-19 to have a known and possible impact need to evaluate whether it is appropriate to present financial statements on a going-concern basis, or disclose if there is a material uncertainty with respect to remaining a going-concern. If the going concern assumption is no longer appropriate and the effect is expected to be pervasive, a fundamental change in the basis of accounting to the liquidation basis or other suitable basis of preparation may be needed.

Entities should consider the level of analysis that may be required based on the level of uncertainty surrounding the going concern assumption and the conclusion reached. An entity may need to conduct robust sensitivity and forecasting analyses to support its position that uncertainties are not considered material uncertainties causing significant doubt about the ability to continue as a going concern. On the other hand, qualitative assessment alone may be sufficient for an entity that has reached the conclusion that material uncertainties exist that cause significant doubt as to the ability to continue as a going concern.

FINANCIAL REPORTING CONSIDERATIONS – POST DECEMBER 31, 2019 FINANCIAL STATEMENTS

For entities with fiscal year-ends or interim periods in 2020, similar assessments to those discussed above will need to be made. In addition, COVID-19 and the related economic effects will have additional impacts on other financial reporting areas, such as valuation and impairment. We highlight some of the financial reporting areas that might be impacted:

Fair value measurements: Financial instruments

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Entities should consider the appropriateness and reliability of market prices for Level 1 and Level 2 securities. COVID-19 is currently causing volatility in financial markets; however, it would not be appropriate to disregard market prices at the measurement date, unless those prices are from transactions that are not orderly. Liquidity in financial markets and access to principal markets with current border restrictions also would be required to be considered, as would the potential impact on movement of securities from Level 1 to Level 2 and Level 3.

Entities also should pay special attention to fair value measurements using Level 3 inputs, and ensure these non-observable inputs are reflective of current economic conditions impacted by COVID-19.

The determination of the principal market should be considered from the perspective of the entity. Due to travel restrictions, certain assets may not be able to be sold in their most advantageous market. This also may impact adjustments made to Level 2 inputs, as a common Level 2 adjustment is the condition or location of the asset. We believe this will have the greatest impact on non-financial assets.

Fair value considerations: Non-financial assets

Several International Financial Reporting Standards (IFRS) provide entities an option to measure assets at fair value. Some of these standards include the following:

- IAS 40, Investment Properties, provides entities with an option to measure eligible properties at their fair values.
- IAS 16, Property, Plant and Equipment, provides entities with an option to use the revaluation method where the fair value can be measured reliably.
- IAS 41, Agriculture, requires entities to record biological assets at fair value less costs to sell, unless the fair value cannot be measured reliably.
- The following are some of the factors entities should consider in their fair value estimates for these non-financial assets:
- Lockdowns, social distancing, travel restrictions and quarantine measures might result in an increase in the number of people working remotely and impact commercial building vacancy rates.
- Lockdowns and border restrictions might have an impact on entities access to principal or most advantageous market. For example, it may not be possible to transport unused plant or equipment into a neighbouring country in which a higher sales price usually could be obtained.
- Decline in risk free rates and changes in market liquidity could impact discounting rates used in fair value estimates.

Additional factors detailed in impairment of non-financial assets should also be considered.

Impairment under IFRS 9, Financial Instruments

Entities with financial instruments (i.e., trade or lease receivables, loans and other receivables, debt instruments not measured at fair value through profit and loss, and contract assets) under the scope of IFRS 9 are required to apply the expected credit loss model for impairment. We anticipate

COVID-19 may have the following impact:

- Entities are required to estimate 12-month or life-time expected credit losses depending on the nature of the financial instrument. At each reporting date, entities are required to assess whether credit risk on a financial instrument has increased significantly since initial recognition. If there is a significant increase in credit risk since initial recognition, entities generally are required to recognize a loss allowance equal to the lifetime expected credit losses.
- Entities holding financial instruments owing from customers or other parties will need to understand whether those customers or other parties are significantly impacted by COVID-19, such as if they are experiencing or are expected to experience financial difficulty. For entities not applying the simplified lifetime approach, financial instruments previously measured using 12-month expected credit losses will likely have to be remeasured using the lifetime expected credit losses.
- In measuring expected credit losses, entities are required to incorporate current conditions and forecasts of future economic conditions. If a debtor's business is expected to be significantly impacted by COVID-19, the expected risk of default might be higher and therefore would warrant a larger credit loss. Entities also will need to incorporate and increase the likelihood of default scenarios due to the virus.
- Entities using a simplified approach to measure expected credit losses and also a provision matrix would have to reassess current and future expected economic scenarios incorporating the COVID-19 impact.

Investments in joint ventures or associates

Entities that apply equity method accounting for joint ventures or significant influence investees may need to evaluate the impact that COVID-19 has on their investments and determine whether there is an indication of impairment.

Impairment of non-financial assets

IAS 36, Impairment, requires entities to test goodwill and indefinite lived intangible assets at a minimum annually and other non-financial assets whenever there is an indicator that assets might be impaired. Current measures enacted by governments requiring businesses to temporarily shut down and social distancing will impact almost all businesses and are likely to be an indication of impairment.

The following are some of the factors entities should consider in their determination of recoverable value of the non-financial asset or Cash Generating Unit:

- Impact of lockdowns, social distancing, travel restrictions and quarantine measures on expected revenue and cost of operations
- Impact that COVID-19 would have on expected growth factors previously estimated for discounted cash flow projections
- Decline in risk free rates and changes in market liquidity, and their impact on discounting rates
- Given uncertainty of future events, building in probability weighted scenarios into expected projections

Under IAS 1, Presentation of Financial Statements, entities also are required to disclose information regarding the assumptions they make about the future, and other major sources of estimation uncertainty at the end of the reporting period that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Inventories

Inventory is required to be subsequently measured at the lower of cost or net realizable value, with losses to be recognized when the net realizable value of the inventory is less than cost. As a result of COVID-19, net realizable value of inventories could be reduced due to lower demand or lower commodity prices. Reduced demand for oil that is attributable to COVID-19, and the resultant significant declines in oil prices, is just one example of a type of inventory for which loss recognition may be warranted.

In addition, in response to the virus, several entities are temporarily suspending production. Entities may need to review their inventory costing methodologies to reallocate capitalized fixed overheads into the income statement.

Restructuring

Entities significantly impacted by COVID-19 may consider a workforce reduction, closure of business locations in a country or region, restructuring, or sale or disposal of a group of assets or division(s). From an accounting perspective, entities should consider the following:

a. A constructive obligation can only be recognized when the entity:

   1. Has a detailed formal plan for the restructuring identifying at least:

      i. The business or part of a business concerned;

      ii. The principal locations affected;

      iii. The location, function and approximate number of employees who will be compensated for terminating their services;

      iv. The expenditures that will be undertaken; and

      v. When the plan will be implemented; and

   2. Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

b. A non-current asset will be classified as held for sale and measured at the lower of its carrying amount and fair value less costs to sell if the carrying amount will be recovered principally through a sale transaction rather than through continuing use.

c. Whether the sale of a division or group of assets represents a discontinued operation under IFRS 5, Non-current Assets Held for Sale and Discontinued Operations.

Onerous contracts

An onerous contract is defined as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. The recent developments and economic impact of COVID-19 may result in the following onerous contracts:

- Revenue contracts where there is a material penalty for late delivery, and there are increased costs of fulfilling the contract due to an increase in raw material costs (as a result of supply chain delays and shortages) and labour costs (due to employees being quarantined or sent home)
- Cancellation of contracts with a significant financial penalty due to quarantines and closures

If the entity identifies onerous contracts, the present obligation under the contract is recognized and measured as a provision.

Debt agreements and covenants

If the impact of COVID-19 causes disruptions that result in cash flow problems, entities may need to amend terms of existing debt agreements or obtain waivers for debt covenants. Thus, debtors may need to determine whether changes to existing debt arrangements represent a modification or extinguishment subject to the accounting requirements of IFRS 9. If there has been a covenant violation or other default at the balance sheet date, debtors also should consider whether the classification of long-term debt needs to be revised in accordance with IAS 1, Presentation of Financial Statements.

Borrowers should remember that, if a covenant is breached, a waiver from the lender must be obtained prior to the entity's reporting date. Otherwise, the debt should be classified as current, even if a waiver is obtained subsequently.

Government grants

With the significant impact COVID-19 has had on the economy, governments are responding by providing grants to small businesses to financially support them. Entities need to assess the terms and conditions attached to the grants to determine when recognition is appropriate. Government grants that become receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs shall be recognized in profit or loss for the period in which it becomes receivable.

Revenue recognition

An entity accounts for a contract with a customer that is within the scope of IFRS 15, Revenue from Contracts with Customers, only when it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. Due to the negative impact COVID-19 has had on the creditworthiness of customers, entities should analyze this criterion with greater rigor and obtain evidence to support or refute that collection is probable at the time the consideration is due.

Under IFRS 15, variable consideration is estimated and included in the transaction price only to the extent it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. The consideration in a contract can vary because of rebates, refunds, performance bonuses and incentives. COVID-19 has resulted in the closure of non-essential businesses and countries encouraging citizens to stay at home. Therefore, the demand for non-essential products will decrease and potentially result in businesses returning a higher volume of items back to suppliers. Furthermore, the overall decline in economic activity will result in lower sales volume. Thus, COVID-19 will have a significant impact on entities estimating various forms of variable consideration. We anticipate entities likely will have to recognize a greater refund liability and adjust consideration to reflect volume incentives and performance bonuses no longer being probable of being met. For entities offering warranties to customers, entities should evaluate the terms and conditions of these warranties and the impact COVID-19 will have on warranty provisions and revenue deferral (in instances where warranties are a separate performance obligation).

Entities also will need to evaluate whether termination penalties and payment rights for performance completed to date remain enforceable. With several companies terminating contracts and experiencing financial difficulty, federal governments are passing laws providing financial relief for businesses, and certain termination and payment rights may no longer be enforceable, which could impact the contract term and pattern of revenue recognition.

Disclosure of financial risk management

Entities are required to disclose exposure to financial risks, such as credit, liquidity, and market risk, and how these risks are being managed. Entities should consider whether COVID-19 has affected their risk exposure and mitigation plans, such as factoring accounts receivable and delaying payments to suppliers.

Insurance receivables

Some entities may hold insurance coverage for business disruptions or loss of profits. Insurance receivables should only be recognized at the point at which receipt is virtually certain, which may be significantly after the corresponding loss event has occurred. Given the prevalence of "force majeure" and other similar clauses within insurance contracts, we believe that the "virtually certain" test will usually only be met at the point when the insurer confirms its intention to pay out a claim. Entities should recognize the proceeds from insurance recoveries in other income in the income statement.

Other considerations

COVID-19 has a number of implications on other areas of the financial statements, such as:

- Appropriateness and continuation of hedge accounting due to change in hedge effectiveness requirements or a transaction no longer being highly probable.
- Probability of meeting earnings and volumes targets in contingent consideration measurement, rebates, customer incentive payments, and bonuses.
- Likelihood of meeting market-based performance conditions such as share prices in stock-based payment arrangements.
- Increased volatility on stock options leading to higher fair values and shared-based payment expense. Similarly, cancellations of employee stock options may lead to immediate recognition of expenses.
- Determination of the useful life and residual value of assets under IAS 16.
- Reconsideration of whether deferred tax assets are fully realizable, particularly if the entity has net operating loss carryforwards expiring in the near term.

Interim financial statements

Under IAS 34, Interim Financial Statements, entities are required to include an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. Therefore, entities should be beginning or continuing to assess the impact of COVID-19 on their financial performance relative to their year-end statements.

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