COVID-19-related financial reporting issues for SME-FRF & SME-FRS financial statements

Background

The coronavirus pandemic and related actions (e.g. government closure orders, travel restrictions and quarantine measures) is having a major impact on businesses, in particular, on small and medium-sized entities. In both March and June 2020, the Institute published guidance on the COVID-19 related financial reporting issues for HKFRS financial statements. Following on from that guidance, this educational guidance highlights some key considerations when preparing financial statements under the Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard (SME-FRF & SME-FRS).

The financial reporting implications of COVID-19 on entities are broad and entities should assess the precise effects on their financial statements considering their facts and circumstances.

Key considerations when preparing the 2019 year-end financial statements

What are the conditions that existed at the end of 31 December 2019?

SME-FRF & SME-FRS defines "*Events after the end of the reporting period*" as events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. Two types of events can be identified:
(a) those providing evidence of conditions that existed at the end of the reporting period (adjusting events); and
(b) those indicative of conditions that arose after the end of the reporting period (non-adjusting events).

Paragraphs 17.1 and 17.3 of the SME-FRS state that "An entity should adjust the amounts recognised in its financial statements to reflect adjusting events after the end of the reporting period." and "An entity should not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the end of the reporting period."

Since 31 December 2019, the development and spread of COVID-19 has resulted in the occurrence of a multitude of associated events. Among these are the identification of the virus, its spread in terms of number of infected and geographical prevalence, actions taken by governments and non-governmental organisations, actions taken by private entities, and the resulting economic effects of these.

In assessing whether events associated with the development and spread of COVID-19 are adjusting or non-adjusting events after the reporting period, entities should exercise judgement and carefully consider their individual facts and circumstances. In our view, the development and spread of COVID-19 (and multitude of associated events) subsequent to the reporting date generally do not provide evidence of conditions that existed at 31 December 2019. Rather, the development and spread of COVID-19 generally evidences conditions that arose after the reporting date. You can also refer to our March guidance for further discussion of events associated with the development and spread of COVID-19.

Accounting and disclosures for COVID-19 in 31 December 2019 year-end financial statements

The outbreak of COVID-19 and its associated events subsequent to the reporting date of 31 December 2019 should generally be accounted for as non-adjusting events under paragraph 17.3 of the SME-FRS. Per paragraph 17.3, an entity should not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the end of the reporting period.

However, per paragraph 17.8 of the SME-FRS, an entity should disclose non-adjusting events if non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions. This disclosure should include, the nature of the event and an estimate of its financial effect. It may be difficult to estimate the financial effect attributable to COVID-19. If an estimate of the financial effect cannot be made, paragraph 17.8(b) requires a statement that such an estimate cannot be made.

Impact of other events beyond the scope of COVID-19

The events associated with the development and spread of COVID-19 should generally be considered non-adjusting events. However, management should also consider whether there are other events beyond the scope of COVID-19 that provide evidence of conditions that existed at the end of the reporting period (adjusting events).

An example of an event after the reporting period is a sale of inventories at a selling price below cost, which provides evidence about a decrease in net realisable value. An entity applies judgement to determine which events contributed to the decrease, and determine whether those events evidence circumstances that existed at the end of the reporting period. For example, if management determines that inventories had decreased in value due to obsolescence unrelated to COVID-19, and the condition of obsolescence existed before the reporting date, this indicates presence of an adjusting event. Management would then need to consider how much of the decrease in net realisable value relates to the obsolescence event. (Paragraph 17.2(b) of the SME-FRS)

During this time, it may be challenging to determine which events have caused an impact to an entity's financial reporting, and to measure their impact independently from the overall non-adjusting impact of COVID-19. Entities should carefully exercise judgement and consider the specific facts and circumstances to achieve a proper presentation in accordance with the SME-FRF & SME-FRS.

Is the business a going concern?

COVID-19 has had a significantly unfavourable impact on some entities. Regardless of whether an event after the reporting period is adjusting or non-adjusting, management should make an assessment of the entity's ability to continue as a going concern when preparing its financial statements. For the purpose of this assessment, management should consider the impact that the outbreak of COVID-19 and its associated events, which have occurred since 31 December 2019, has had on the entity.

When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, those uncertainties should be disclosed. Financial statements should be prepared on a going concern basis unless management either intends to liquidate the entity or cease trading, or has no realistic alternative but to do so. (Paragraph 1.6 of the SME-FRS)

You can also refer to our March guidance for examples of the type of information that management should take into account when determining whether the going concern assumption is still appropriate.

When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not considered to be a going concern (paragraph 1.6 of the SME-FRS). In this event, as SME-FRF & SME-FRS does not specify the basis of accounting to change to, entities will need to carefully assess their situation and circumstances.

Key considerations when preparing the 2020 year-end financial statements

The requirements highlighted above for going concern and events after the end of the reporting period will also be key consideration when preparing 2020 year-end financial statements. The following are some other key considerations that warrant specific attention for 2020 year-ends:

- ***Impairment of assets:*** Due to the outbreak of COVID-19, a number of impairment indications may exist, including, for example, government closure orders for factories and shops, reduced demand from customers and debtors not repaying debts on time due to financial difficulties.

  If indications of impairment exist, an entity should estimate the recoverable amount of all assets (other than inventories, construction contracts and current investments) to determine whether an impairment loss should be recognised in profit or loss (paragraph 9.1 of the SME-FRS).

- ***Measurement of inventories:*** Paragraph 7.1 of the SME-FRS states that inventories should be measured at the lower of cost and net realisable value (NRV). NRV is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Given the current market conditions, the NRV calculation may involve greater judgement.

- ***Government grants:*** To alleviate the financial burden suffered by individuals and businesses under COVID-19, the Hong Kong SAR Government launched a series of support measures, including employment support schemes (e.g. wage subsidies), sector-specific reliefs (e.g. cash subsidies to different sectors), rent concessions and provision of concessionary interest loans with government guarantees.

  An entity should not recognise a government grant until there is reasonable assurance that the entity will comply with the conditions attaching to it and the grant will be received. Government grants should be recognised as income over the periods necessary to match them with the related costs they are intended to compensate, on a systematic basis (paragraphs 12.1 – 12.2 of the SME-FRS).

  Government grants related to assets should be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset (paragraph 12.5 of the SME-FRS).

  Grants related to income (e.g. wage subsidies) are sometimes presented as a credit in the income statement, either separately or under a general heading such as "Other income"; alternatively, they are deducted in reporting the related expense (paragraph 12.6 of the SME-FRS).

  Concessionary interest loans with government guarantees is a form of government assistance which the entity is required to disclose its nature and duration in the financial statements (paragraphs 12.8 – 12.11 of the SME-FRS).

- ***Rent concessions from lessors:*** Different forms of rent concessions have been offered, or are expected to be offered, by lessors to lessees due to the COVID-19 pandemic. There is no specific accounting requirements set out in the SME-FRF & SME-FRS for rent concessions in lessees' financial statements. Entities should follow paragraphs 2.1 and 2.2 of the SME-FRS in developing its accounting policy.

- ***Breach of loan covenants:*** The current conditions arising from COVID-19 may result in an entity breaching a loan covenant. If an entity breaches a provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach (paragraphs 1.17 and 1.18(b) of the SME-FRS). However, an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment (e.g. borrowers may be able to obtain "comfort letters" from their lenders) indicating that loans will not be called within the next twelve months.

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