COVID-19-related financial reporting issues for 2020 reporting periods

Background

Due to the outbreak of the COVID-19 pandemic, related actions (e.g. government closure orders, travel restrictions and quarantine measures) and resultant economic effect, businesses have been seriously impacted locally and globally. These circumstances have resulted in increasing challenges for entities when preparing their financial statements. In early March, the Institute published educational guidance[1] that focused on some key financial reporting implications of COVID-19, including highlighting some key requirements for events after the reporting period, going concern and disclosures about key judgements and estimates in preparing financial statements. That guidance was aimed primarily at reporting periods ended on 31 December 2019, but the principles highlighted were also relevant to interim and future reporting periods.

This educational guidance highlights some other financial reporting considerations in the light of COVID-19 that warrant specific attention for 2020 interim and annual financial statements. In particular, this publication highlights some key considerations in the following areas:

1. Expected credit losses
2. Impairment of non-financial assets
3. Fair value measurements
4. Revenue recognition
5. Government grants
6. Rent concessions
7. Property, plant and equipment
8. Measurement of inventories
9. Breach of loan covenants
10. Interim financial reporting

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.

1. Expected credit losses

HKFRS 9 *Financial Instruments* requires entities to estimate and account for expected credit losses (ECL) on financial assets, including leases receivables, contract assets, loan commitments

[1] https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/03_Our-views/Financial-Reporting-Auditing-and-Ethics-Alert/alert33a.pdf

and financial guarantee contracts, subject to its impairment requirements. The current uncertain environment creates challenges in estimating ECL applying HKFRS 9.

Implications of support measures*:* Certain governments and local banks have introduced various relief measures to support borrowers affected by COVID-19. These could be in the form of payment holidays on existing loans. Entities giving such support need to consider the impact on their financial statements, in particular, whether payment holidays indicate the affected loans have suffered a significant increase in credit risk or default, and therefore moved to stage 2 or 3 of the ECL model. Entities should carefully assess the terms and conditions of the extension of payment terms. For example, the extension of payment holidays to all borrowers in particular classes of financial instruments should not automatically result in all those instruments being considered to have suffered a significant increase in credit risk for the purpose of determining ECL[2]. However, entities still need to consider whether there are other indicators of significant increase in credit risk. If the relief measures are available only to those who meet certain criteria, entities should assess whether those criteria might indicate a significant increase in credit risk.

Credit enhancements, such as guarantees, are also provided by some governments and banks to ensure partial or full recovery of the loan amounts affected by COVID-19. Entities need to assess whether such credit enhancements are integral to the loans/receivables or should be recognised as a separate reimbursement asset or a government grant under HKAS 20 *Accounting for Government Grants and Disclosures of Government Assistance*. Paragraph B5.5.55 of HKFRS 9 requires that only credit enhancements that are part of the contractual terms and are not recognised separately by the entity shall be reflected in the measurement of ECL.

Re-visiting the models and assumptions: In light of the current uncertainty arising from COVID-19, entities will need to revisit their models and assumptions used in measuring ECL. In particular, entities need to exercise judgement in considering multiple macroeconomic scenarios that reflect the changes in economic conditions and the probability weighting assigned to the scenarios, for example, to reflect the downside scenarios and/or to increase their weighting due to COVID-19. If the effects of COVID-19 cannot be reflected in the models, top-down management overlays or adjustments will need to be considered.

Re-segmentation of loan portfolios or receivables: The occurrence of COVID-19 may change the risk characteristics of certain loans or receivables because borrowers or customers might engage in businesses, or be located in areas that are affected by COVID-19 in different ways. Therefore, entities should consider re-segmenting their portfolios so that they are grouped on the basis of shared credit risk characteristics (paragraph B5.5.5 of HKFRS 9). For trade receivables, entities need to consider whether to apply the provision matrix at a more granular level or to assess a greater number of receivables on an individual basis.

Credit risk disclosures: Given the uncertainty arising from COVID-19 and the significant judgement involved in estimating ECL, disclosure of the key assumptions and the estimation techniques used is particularly important for users of financial statements to understand the impact of COVID-19 on ECL estimation. Such disclosures include the values of the key macroeconomic inputs used in the multiple economic scenarios and the probability weights assigned to these scenarios, the effect of management overlays and judgements made on how and the extent to which related support measures have been factored into the assessment of ECL.

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[2] Refer to the IASB's educational statement *Accounting for expected credit losses applying IFRS 9 Financial Instruments in the light of current uncertainty resulting from the covid-19 pandemic* (https://cdn.ifrs.org/-/media/feature/supporting-implementation/ifrs-9/ifrs-9-ecl-and-coronavirus.pdf?la=en).

Entities are reminded to refer to HKFRS 7 *Financial Instruments: Disclosures* for the relevant disclosure requirements, and provide disclosures that are specific to the entity's circumstances.

2. Impairment of non-financial assets

Paragraph 9 of HKAS 36 *Impairment of Assets* requires an entity to assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset (the higher of its fair value less costs of disposal and its value in use). For goodwill and intangible assets with an indefinite useful life or not yet available for use, paragraph 10 of HKAS 36 requires an entity to test for impairment annually (irrespective of whether there is any indication of impairment) and also when there is any indication that the asset may be impaired.

Indication of impairment: Due to the outbreak of COVID-19, a number of impairment indications may exist for many assets and cash-generating units (CGUs), including, for example, government closure orders for factories and shops, reduced demand from customers and evidence from internal reporting that actual performance is significantly lower than management forecasts. If any such indication exists, entities are required to estimate the recoverable amounts of those assets and/or CGUs to assess whether to recognise impairment losses.

Identification of CGU: Due to the existence of potential new impairment indicators following the outbreak of COVID-19, many assets may need to be tested for impairment for the first time. Different jurisdictions may be affected by COVID-19 differently and if assets need to be allocated to CGUs for impairment testing, this allocation will often need to be made at a lower CGU level than the country level. Judgement is required to determine the appropriate CGU level for impairment testing.

Present value techniques: When using present value techniques to estimate the recoverable amount of an asset or a CGU, the assumptions and cash flow projections used must be updated to reflect the potential effects due to COVID-19. Instead of using the traditional approach in HKAS 36, which uses a single set of expected cash flows, the expected cash flow approach in HKAS 36, which uses all expectations about possible cash flows, may in some situations better reflect the range of possible outcomes and related risks in light of the current uncertainty due to COVID-19. Assumptions and cash flow projections used in impairment tests of different assets should be consistent with each other and align with market evidence.

Disclosures: Disclosure requirements under HKAS 36 and HKFRS 13 *Fair Value Measurement*, about the key assumptions and judgements applied in estimating the recoverable amount are of vital importance to investors given the current uncertainty, including a description of management's approach to determining the values assigned to the key assumptions and the information about the sensitivity of recoverable amount to changes in those key assumptions.

3. Fair value measurements

Paragraph 2 of HKFRS 13 states that the objective of fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions.

Fair value hierarchy and approach: The effects of COVID-19 may create challenges in obtaining the fair value of an asset due to highly volatile markets and/or a significant decrease in the volume of transactions (and in some cases, the market may no longer be active). The level in the fair value hierarchy for inputs into fair value measurements may shift, e.g. from level 2 to level

3 due to a lack of observable inputs. Entities need to ensure that the unobservable inputs reflect how market participants would incorporate the effect of COVID-19.

When a present value technique is used for fair value measurements, appropriate cash flows and discount rates must be estimated based on the current market conditions at the measurement date. As described for item 2, assumptions used must reflect the potential effects due to COVID-19, and in order to better reflect the range of possible outcomes and related risks, entities may apply an expected cash flow approach.

Disclosures: HKFRS 13 specifies disclosure requirements to address the measurement uncertainty in relation to level 3 fair value measurements, including about the sensitivity of the fair value measurement to changes in the unobservable inputs and the significant judgements applied in fair value measurement.

Use of valuation experts: The significant uncertainty related to COVID-19 also creates challenges for the valuation profession. The International Valuation Standards Council has issued a letter and guidance on the implications of COVID-19 on valuation[3]. In addition to challenges caused by the market uncertainty/volatility, valuers may not be able to perform the valuation properly due to government restrictions, e.g. lockdown measures in some jurisdictions, which may limit the scope of work. The impact of COVID-19 on valuations may affect the reliability of the valuation report for accounting and auditing purposes and valuation reports may need to include appropriate caveats, eg restrictions on information or on physical inspection.

<u>4. Revenue recognition</u>

HKFRS 15 *Revenue from Contracts with Customers* establishes the core principle that an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

As a result of the COVID-19 pandemic and the related government measures and actions in many jurisdictions, there may be significant changes in circumstances for both an entity and its customers.

Enforceability: A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Business disruptions from the COVID-19 pandemic may cast doubt on the enforceability of contract terms (e.g. how COVID-19 will be considered in the legal interpretation of clauses, such as "*force majeure*" or similar clauses).

Collectability: Contracts with customers are only accounted for under HKFRS 15 when they meet all of the criteria under paragraph 9 of the standard, which includes collectability of consideration in exchange for goods and services transferred to the customer is probable. If a contract with a customer meets the criteria in paragraph 9 of HKFRS 15 at contract inception, an entity shall not reassess those criteria unless there is an indication of a significant change in facts and circumstances. As a result of the COVID-19 pandemic, customers may be experiencing financial difficulties that significantly affect their ability to pay and an entity should reassess whether collectability of the consideration remains probable.

[3] https://www.ivsc.org/files/file/view/id/1719
https://www.ivsc.org/news/article/statement-in-relation-to-the-covid-19-pandemic

If an entity reassesses that collectability is no longer probable for existing contracts with a customer, this may also indicate there may be collectability issue for new contracts entered with this customer.

When a contract with a customer does not meet the criteria in paragraph 9 of HKFRS 15, the entity recognises any consideration received from the customer as revenue only when either of the following events has occurred:

(a) the entity has no remaining obligations to transfer goods or services to the customer and substantially all of the consideration promised by the customer has been received by the entity and is non-refundable; or

(b) the contract has been terminated and the consideration received from the customer is non-refundable.

The entity needs to assess any related contract assets or accounts receivable for impairment (see item 1 above for some considerations on estimating expected credit losses on financial assets). In addition, the entity shall continue to assess the contract to determine whether the criteria in paragraph 9 of HKFRS 15 are subsequently met.

As a result of COVID-19, entities may decide to offer extended payment terms to some customers. This may indicate a collectability issue (i.e. whether it remains probable that the entity will collect the consideration). If collectability is probable, entities need to evaluate whether there is a significant financing component in accordance with paragraphs 60-65 of HKFRS 15.

Customer incentives: In response to the current market situation, many entities have provided, or expect to provide, various schemes to incentivise or compensate customers. Challenges may arise in a number of areas, including whether a change in the consideration (i.e. cash rebate, refunds, discounts, etc.) is a result of a contract modification, or a resolution or change in the estimation for variable consideration. On one hand, contract modifications are accounted for by applying paragraphs 20-21 of HKFRS 15. On the other hand, the requirements for estimating variable consideration, including constraining those estimates, are in paragraphs 50-59 of HKFRS 15; in particular, entities shall update the estimated transaction price (including updating the assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances at the end of the reporting period and the changes in circumstances during the reporting period.

To mitigate the decline in sales, entities may offer discounts on future goods or services to customers. Judgement may be required to determine whether the incentive represents a material right associated with the existing contract to be accounted for in accordance with paragraph B40 of HKFRS 15, or a payment to a customer that shall be recognised as a reduction in revenue applying paragraph 72 of HKFRS 15. The discounted price on future goods or services may also impact estimates of the standalone selling price for future contracts.

Entities may provide free or discounted goods to existing customers that are not included in an existing contract. Entities need to evaluate whether the additional promised goods is a modification of an existing contract (because it results in a change to the scope of that contract) or a new contract, which might need to be combined with an existing contract (based on the criteria in paragraph 17 of HKFRS 15). In addition, entities need to evaluate whether the additional incentives offered create implied promises or performance obligations for future contracts, i.e. implied by the entity's customary business practices.

Measuring progress: Because of the significant disruption to entities' operations as a result of the COVID-19 pandemic, entities may need to reconsider the timing of revenue recognition if they are unable to satisfy their performance obligations in a timely manner. When entities use a cost-based input method to measure progress for over-time revenue recognition, they must exclude costs that do not depict the entities' performance in transferring control of goods or services to the customers, for example, any abnormal costs incurred due to the effects of COVID-19. Paragraph B19 of HKFRS 15 provides circumstances when an adjustment to the measure of progress may be required.

Disclosures: The objective of the disclosure requirements in HKFRS 15 is to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Entities will need to consider how to reflect the implications arising from COVID-19 highlighted above in their disclosures, including any significant changes in contract balances during the reporting period e.g. due to impairment, changes in the timeframe for a performance obligation to be satisfied, and significant judgements made in the application of the standard and changes in those judgements.

5. 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 in response to COVID-19, 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.

Scope: Entities need to evaluate all of the government assistance they receive, and their facts and circumstances, to determine the appropriate accounting treatment. Government support measures may fall within the scope of different standards, including HKAS 12 *Income Taxes*, HKAS 20, HKFRS 9 and HKFRS 16 *Leases*.

Recognition: HKAS 20 defines government grants as assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. An entity shall not recognise a government grant until there is reasonable assurance that the entity will comply with the conditions attaching to the grant and the grant will be received. Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

Presentation: A government grant related to assets shall 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. A government grant related to income (e.g. wage subsidies) shall be presented as part of profit or loss, either separately or under a general heading such as "Other income"; alternatively, they are deducted in reporting the related expense.

Government supported loans: Government support may be in the form of concessionary low-interest loans with government guarantees. Paragraph 10A of HKAS 20 states the benefit of a government loan at a below-market rate of interest is treated as government grant. The loan is recognised and measured in accordance with HKFRS 9. The benefit of the below-market rate of interest is measured as the difference between the initial carrying amount of the loan determined in accordance with HKFRS 9 and the proceeds received. This benefit is accounted for in accordance with the general principles of HKAS 20. A similar treatment would be applied to a concessionary low-interest loan with a government guarantee. The entity is required to consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

6. Rent concessions

Different forms of rent concessions have been offered, or are expected to be offered, by lessors to lessees due to the COVID-19 pandemic. *Covid-19-Related Rent Concessions* (Amendment to HKFRS 16) issued in June 2020 provides a practical expedient that a lessee may elect not to assess whether a COVID-19-related rent concession is a lease modification. A lessee that makes this election would account for such a rent concession in the same way as if the change were not a lease modification. No change has been made to lessor accounting (See separate educational material on COVID-19-related rent concessions[4] for guidance).

If a lessee does not elect to use the practical expedient for particular rent concessions, or those rent concessions do not qualify for the application of the practical expedient (i.e. the conditions under paragraph 46B of HKFRS 16 are not met), the lessee assesses whether the rent concessions meet the definition of lease modifications (applying paragraphs 44-46 of HKFRS 16) (See separate educational material on rent concessions[5] for guidance).

If a rent concession is accounted for as a lease modification, a revised discount rate is used for discounting the revised lease payments. Determining an appropriate discount rate, particularly the incremental borrowing rate of the lessee when the interest rate implicit in the lease is not available, is challenging and involves significant judgement.

7. Property, plant and equipment

An entity's development and construction projects may be interrupted due to restrictions on activities imposed by government due to COVID-19, cash flow difficulties or a desire to pause development in uncertain market conditions.

Capitalisation of borrowing costs: Paragraph 8 of HKAS 23 *Borrowing Costs* requires an entity to capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Paragraph 20 of HKAS 23 requires the suspension of capitalisation of borrowing costs during extended periods in which an entity suspends active development of a qualifying asset.

If an entity's development and construction projects are interrupted for an extended period due to restrictions on activities imposed by government due to COVID-19, borrowing costs incurred during the period of suspension will generally be required to be recognised as an expense.

However, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work or when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

Depreciation of idle assets: Paragraph 55 of HKAS 16 *Property, Plant and Equipment* states that depreciation does not cease when the asset becomes idle or is retired from active use unless

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[4] https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/06_New-and-major-stds/ag_rent.pdf
[5] https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/06_New-and-major-stds/ie161.pdf

the asset is fully depreciated. Therefore, entities shall continue to recognise depreciation while that asset is temporarily idle. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

8. Measurement of inventories
As part of the government measures to reduce the spread of COVID-19, factories in many countries, including the PRC, have been forced to close for a period of time. During the suspension of the operations of the factories, fixed overhead costs e.g. rent, fixed labour costs, depreciation of idle plant, are still incurred.

Inventories are 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.

Paragraph 30 of HKAS 2 *Inventories* requires entities to estimate NRV based on the most reliable evidence at the time the estimate is made. Given the current market conditions, the NRV calculation may be more challenging and require more detailed methods or assumptions.

Paragraph 13 of HKAS 2 requires that the amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred.

If an entity is forced to temporarily close its factory or significantly reduce production for a period of time, a significant portion of fixed overhead may need to be expensed as incurred rather than capitalised as part of the cost of the inventory.

9. Breach of loan covenants
The current conditions arising from COVID-19 may result in an entity breaching a loan covenant. In particular, entities should consider any repayment on demand clauses and classification of the loan at the reporting date.

Paragraph 74 of HKAS 1 *Presentation of Financial Statements* requires that when 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.

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 (paragraph 75 of HKAS 1).

10. Interim financial reporting
The development and spread of COVID-19, including actions taken in relation to COVID-19, have largely occurred since the start of 2020 and have been difficult to predict. Consequently, entities may have only provided limited information about the effect of COVID-19 in their 2019 annual financial statements.

Paragraph 15 of HKAS 34 *Interim Financial Reporting* requires an entity to include in its interim financial report 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. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report.

Accordingly, entities that prepare their first interim financial statements since the annual period preceding the outbreak of COVID-19 (e.g. entities with 31 December year-ends) may need to provide more comprehensive disclosures to enable users of the financial statements to understand the effect of the outbreak of COVID-19 and related events on its financial statements.

9 June 2020