CPA
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Alert

Updates on financial reporting, auditing and ethics

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Dear members,

<u>Financial reporting implications of coronavirus</u>

The current outbreak of coronavirus (COVID-19) has significantly affected entities and economic activity in Hong Kong and the broader region.

This publication considers HKAS 10 *Events after the Reporting Period* and related HKFRS financial reporting implications of coronavirus. In particular, it considers whether the spread of COVID-19 should be accounted for as an adjusting or non-adjusting event.

This publication is designed for reporting periods ending 31 December 2019; however, the principles it discusses are relevant for all reporting periods.

Background

On 31 December 2019, the World Health Organisation was informed that a limited number of cases of pneumonia, of an unknown cause, were detected in Wuhan, Hubei. On 7 January 2020, Chinese authorities identified a new type of coronavirus (COVID-19) as the cause. The first cases of COVID-19 were confirmed in Hong Kong on 23 January 2020.

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.

HKAS 10 analysis

HKAS 10 defines ***events after the reporting period*** as those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. There are two types of events:

(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**).

The conditions that existed at the end of the reporting period (assumed to be 31 December 2019 throughout this guidance) were that a limited number of cases of pneumonia, of an unknown cause, had been detected in Wuhan, and that this information was communicated to the World Health Organisation.

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, as described above. Rather, the development and spread of COVID-19 generally evidences conditions that arose after the reporting date. Entities should consider that:

- The increase in transmission and geographical spread of COVID-19 largely occurred after the reporting period, as at 31 December 2019 there were only a limited number of cases concentrated in Wuhan, Hubei. When a new host is infected with COVID-19, that infection is a new condition to that host.
- Actions (e.g. travel restrictions and quarantine measures) taken by governments, non-governmental organisations, and private entities in relation to COVID-19, which are publicly knowable and could reasonably have been deemed to affect an entity's financial statements, have substantially all occurred after the reporting period.
- Resultant economic effects related to COVID-19 have largely arisen as a result of events that have taken place after the reporting period, such as those listed above.

Therefore, the events resulting from the development and spread of COVID-19 after 31 December 2019 should generally be accounted for as non-adjusting events.

<u>Accounting and disclosures for COVID-19</u>

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 HKAS 10. Per HKAS 10, paragraph 10, an entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period.

However, per HKAS 10, paragraph 21, an entity shall disclose non-adjusting events if they are material. This disclosure should include, for each material category of non-adjusting event, 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 for disclosure purposes, HKAS 10 requires a statement that such an estimate cannot be made.

Entities should also note the requirements in HKAS 1 *Presentation of Financial Statements*, paragraph 122, to disclose judgements made in the process of applying the entity's accounting policies, and HKAS 1, paragraph 125, to disclose information about sources of estimation uncertainty.

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. [Refer: HKAS 10, paragraph 9(b)]

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 fair presentation and compliance with HKFRSs.

Other relevant considerations

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 assess and make a determination 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. In particular, management should consider whether events after the reporting period related to COVID-19 have resulted in a need to consider whether the going concern assumption is still appropriate, and whether there are material uncertainties that may cast significant doubt on the ability to continue as a going concern.

In general, financial statements should be prepared on a going concern basis unless management determines it intends to liquidate the entity or to cease trading, or that it has no realistic alternative not to do so. Information that management should take into account when determining whether the going concern assumption is still appropriate includes:

- All available information about the future at least (but not limited to) twelve months from the end of the reporting period.
- History of operations and access to financial resources.
- Depending on the circumstances, a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing.

Entities should refer to HKAS 1, paragraphs 25-26, and HKAS 10, paragraphs 14-16, for the going concern requirements.

Accounting in event that the entity is no longer a going concern (or there is significant doubt)

If it is determined that the going concern assumption is no longer appropriate, HKAS 10 requires a fundamental change to the basis of accounting. In this event, as HKFRS does not specify the basis of accounting to change to, entities will need to carefully assess their situation and circumstances.

Additionally, HKAS 1 requires disclosures in the event that either:

- An entity does not prepare financial statements on a going concern basis.
- Management is aware of material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. These events or conditions may arise after the reporting period.

Entities should refer to HKAS 1, paragraph 25, for the disclosure requirements, and IFRS Interpretations Committee agenda decisions in IFRIC *Update* July 2010 (which explains that applying the disclosure requirements requires the exercise of professional judgment), and IFRIC *Update* July 2014 (which explains that paragraph 122 of HKAS 1 applies to judgements made in concluding there are no material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern) for implementation guidance[1].

Interim reporting considerations

As uncertainty persists about the economic impact of COVID-19, entities should bear in mind that the overall requirements of HKAS 1 in respect to going concern apply to both a complete set of financial statements and condensed interim financial statements. The requirement in HKAS 1 to consider all available future information twelve months from the end of the reporting period, noted above, also applies from the end of the interim reporting date.

Estimates and measurements under other Standards

Given that the outbreak of COVID-19 and its associated events after 31 December 2019 are generally non-adjusting, entities should carefully consider estimates used at the reporting date to ensure they only reflect conditions that existed at the end of the reporting period, and do not introduce hindsight into those measurements.

Entities should pay careful attention to the above in respect of any areas where such estimates need to be made, including but not limited to:

- HKAS 2 *Inventories*: The measurement of net realisable value of inventory.
- HKAS 16 *Property, Plant and Equipment*: The determination of remaining useful life and residual value of assets.

[1] https://cdn.ifrs.org/-/media/feature/supporting-implementation/agenda-decisions/ias-1-going-concern-disclosure-july-2010.pdf. https://cdn.ifrs.org/-/media/feature/supporting-implementation/agenda-decisions/ias-1-disclosure-requirements-relating-to-assessment-of-going-concern-jul-14.pdf.

- HKAS 36 *Impairment of Assets*: The measurement of recoverable amounts and assessing whether an indication of impairment exists for non-financial assets.
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*: The measurement of liabilities including provisions for onerous contracts.
- HKFRS 4 *Insurance Contracts*: The measurement of insurance contract liabilities.
- HKFRS 9 *Financial Instruments*: The measurement of expected credit losses, which should reflect a probability-weighted estimate of credit losses based on information available at the reporting date. This consideration is also applicable to financial guarantee contracts not measured at fair value through profit or loss.
- HKFRS 13 *Fair Value Measurement*: The fair value measurement of assets and liabilities, which should reflect current market conditions, and the assumptions of market participants, as of the measurement date.

Sincere regards,

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