Impact of COVID-19 on Accounting and Corporate Reporting for Financial Services

7 May 2020

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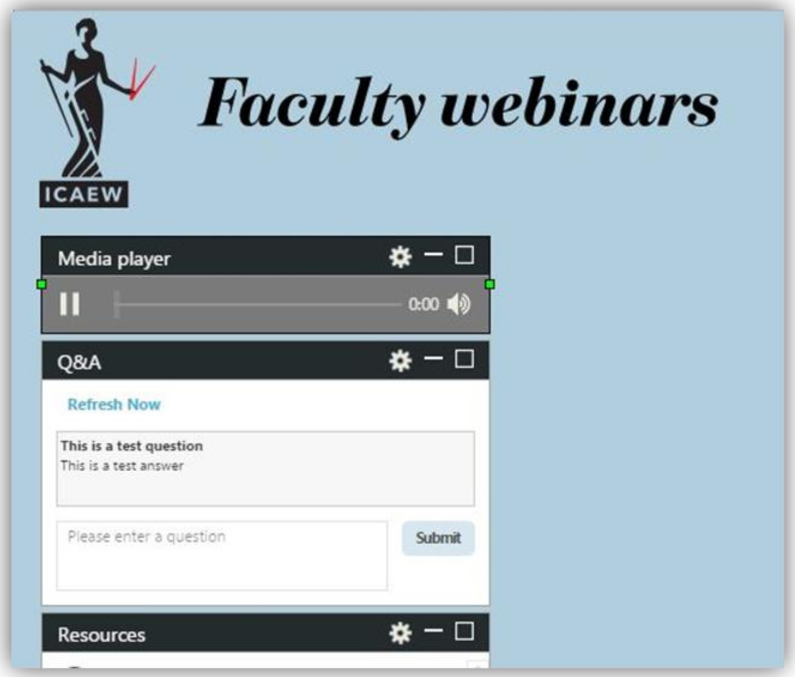

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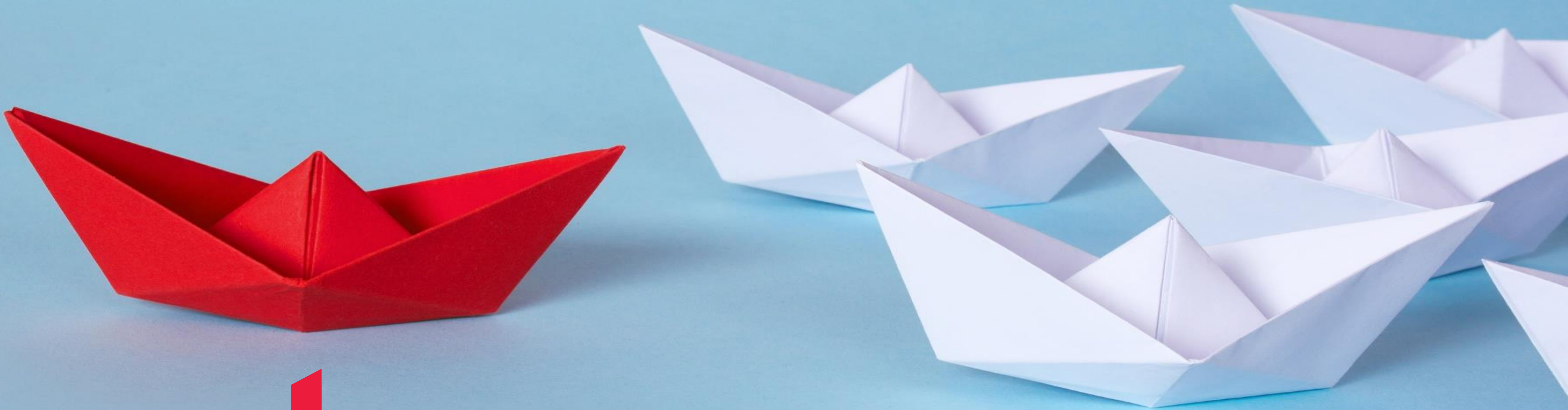
COVID-19 IMPACT ON ACCOUNTING AND CORPORATE REPORTING

7 May 2020



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AGENDA

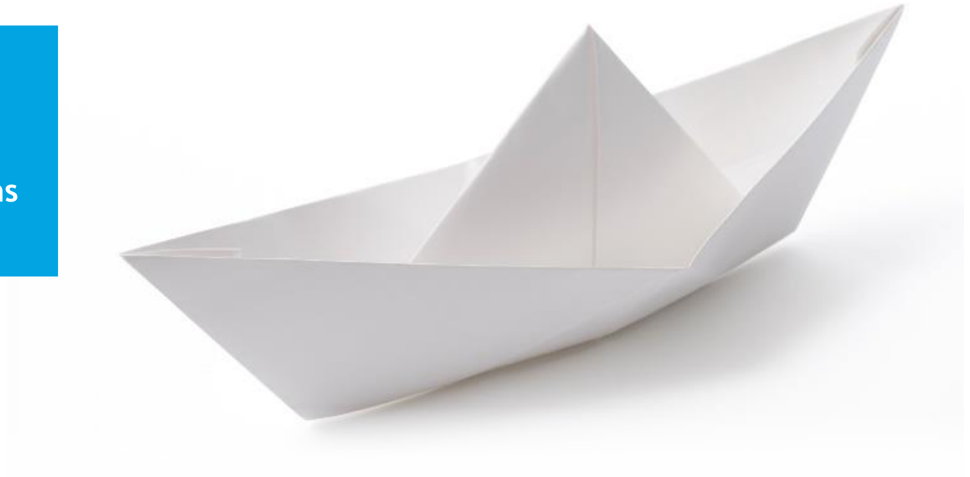
01
Context

02
Accounting and financial reporting considerations

03
Corporate reporting considerations

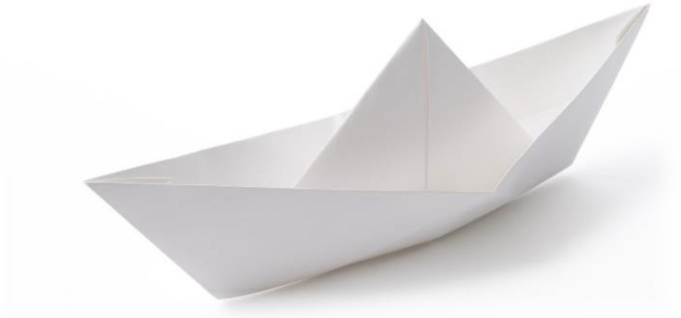
The IASB, at its April Board Meeting, agreed, to:

- extend the consultation period for some major on-going consultations; and
- delay publication of forthcoming major consultations that were originally planned for 2020.



CONTEXT

- The 2019 Novel **Coronavirus infection ('coronavirus' or 'COVID-19')** has had a significant and adverse impact on many economies around the world
- The effects of the coronavirus will be **very wide spread and will impact** a vast range of entities and sectors
- **Accounting and financial reporting** implications for entities will be similarly broad, and the precise effects will be unique to each entity, depending upon facts and circumstances
- As the effects of the outbreak change and evolve, it may become **difficult to distinguish between** which facts and circumstances should be:
  - incorporated into measurement as at period-end, and
  - which should result in potential subsequent event disclosure
- The WHO declared the coronavirus outbreak to be a Public Health Emergency of International Concern on the **30th January 2020**
- Significant measures were **not taken by private sector organisations** until early 2020
- The effects of the coronavirus were generally a **'non-adjusting event'** up until 31 December 2019 under both IFRS and UK GAAP
- Forecasts and assumptions used in preparing financial statements as at **31 December 2019** would therefore reflect little change as a result of the outbreak
- The impact of the coronavirus would require **disclosure** though
- For reporting periods ending **on or after 31 January 2020,** the effects of the coronavirus would need to be incorporated into recognition and measurement.



CONTEXT

Going concern

- Management should **assess** the entity's ability to continue as a going concern and provide appropriate disclosures
- Financial statements to be prepared on a going concern basis **unless** the entity:
  - is being **liquidated**;
  - **ceasing** to trade; or
  - there is **no realistic alternative** but to do either

  [IAS 1.25 and FRS 102.3.8]
- In the UK, this **'look forward'** assessment should consider all available information about the future…
- **And be for at least 12 months from the date of approval of the financial statements**
  - information available beyond 12 months and relevant to the assessment is to be included as well
- The assessment will need to **incorporate** unprecedented shocks to forecasts
  - **With this being the case for 31 December 2019 year-ends**
- Entities are to **consider**:
  - the significant uncertainty surrounding the outcome of future events;
  - model multiple scenarios; and
  - weigh their likelihood
- Levels of uncertainty that may exist in an assertion that the entity will be able to continue as a going concern are **increased**
- Entities to disclose **key judgments and estimates used to arrive at this conclusion**, including:
  - sources of assumed liquidity and cash flows;
  - assumptions surrounding compliance with covenants, contractual agreements and/or regulatory requirements;
  - forecasts of future revenue;
  - assumptions surrounding length of time and severity of disruption to operations;
  - support from various levels of government, including financial assistance.

ACCOUNTING AND FINANCIAL REPORTING

Impairment of non-financial assets

Potential impact of the virus	Some of the things you should be thinking about
▶ Indicators of impairment may exist for assets subject to impairment, e.g. ○ goodwill; ○ intangible assets; ○ property, plant and equipment; ○ investment property not measure at fair value; ○ right-of-use asset; and ○ investments in associates and joint ventures accounted for using the equity method ▶ Value-in-use calculations **may need to be adjusted**, e.g. cash flows revised and/or discount rate adjusted ▶ Fair value less costs of disposal / to sell **may decrease** ▶ Active markets for certain types of assets **may disappear**.	▶ Cash flows included in either a value-in-use or a fair value less costs of disposal / to sell calculation **need to consider all available information** ▶ Cash flow forecasts will need to **incorporate some severe 'down side' forecasts** to account for disruption to operations ▶ Multiple scenarios are to be considered when determining value-in-use or fair value less costs of disposal / to sell due to high level of uncertainty ▶ But the estimation of the recoverable amount is to be based on reasonable and supportable information that existed **as at the reporting date** ▶ **Importance of disclosure** has increased as a result.

Current position on depreciation of non-financial assets that are idle or retired from active use is it does not cease.

ACCOUNTING AND FINANCIAL REPORTING

Investments in associates and joint ventures

Potential impact of the virus	Some of the things you should be thinking about
▶ The **following investments** are to be accounted for using the **equity method**: ○ associates ○ joint ventures ▶ The **carrying value** will be adversely impacted due to: ○ reductions arising as a result of **recognition of losses incurred** in accordance with application of the equity method ○ **possible impairment** of the residual amount ▶ Entities may be required to record liabilities for losses incurred **beyond** the carrying value of their investment ○ due to, e.g., the provision of guarantees or commitments of support.	▶ Entities with long-term interests that are **in substance debt** are to recognise: ○ expected credit losses in accordance with the requirements of IFRS 9; or ○ incurred credit losses in accordance with the requirements of Section 11 of FRS 102 or IAS 39 **before** applying the equity method ▶ COVD-19 may result in applying the impairment requirements of: ○ IAS 36; or ○ Section 27 of FRS 102 **more commonly** to the remaining carrying value of investments in associates and joint ventures.

ACCOUNTING AND FINANCIAL REPORTING

Leases

Potential impact of the virus	Some of the things you should be thinking about
▶ Possible impairment to right-of-use assets ▶ The assessment of when 'no more than an insignificant penalty' exists for lessee and lessor may change ▶ Landlords may offer concessions to tenants (e.g. rent free periods, deferral of payment, etc.) to compensate for disruption to operations ▶ Could result in changes to: ○ the lease term; and ○ result in re-measurements.	▶ Accounting for concessions may have given rise to lease modifications BUT ▶ IASB has proposed an amendment to IFRS 16 very quickly to provide lessees: ○ with an exemption from assessing whether a COVID-19-related rent concession is a modification; ○ so as to treat rent concession as a variable payment The availing of the exemption would require disclosure ▶ Is to be applied retrospectively but not require the restatement of prior period figures ○ i.e. recognise any difference arising on initial application opening retained earnings ▶ Only applies to rent concessions occurring as a direct consequence of COVID-19 ▶ Impairment of lease receivables in lessor's books to be recognised in accordance with the requirements of IFRS 9 or Section 11 of FRS 102 / IAS 39.

ACCOUNTING AND FINANCIAL REPORTING

Financial instruments, including incurred credit losses

Modifications to financial assets and liabilities

- Lenders and borrowers may enter into agreements to **modify** the terms of financial instruments
- Modifications may take **various forms**:
  - reduced interest rates,
  - payment holidays, and
  - covenant waivers
- Section 11 of FRS 102, IAS 39 and IFRS 9 have specific requirements for the modification of assets (for lenders) and liabilities (for borrowers)
- These modifications will generally give rise to **gains for borrowers and losses for lenders**

Decrease in hedge effectiveness

- This may arise due to the **forecast transaction no longer being highly probable**
- May give rise to cash flow hedge accounting being **discontinued**.

Credit-impaired / default definition

- Consider actions that are and will take place to **support borrowers**, including the offer of payment holidays
- PRA's expectation is that **using such should not** automatically trigger a default for accounting or CRR purposes
- This **applies to both** collective and individual assessments

Borrowers who breach covenants due to COVID-19

- Loan covenants play an important role **in lenders' credit risk management**
- Important such risk management distinguishes between 'normal' and **COVID-19 induced** covenant breaches
- Lenders should **consider waiving** COVID-19 induced covenant breaches
- Firms should **act in good faith** and not impose new charges or restrictions on borrowers following a covenant breach that are unrelated to the facts and circumstances that led to that breach.

ACCOUNTING AND FINANCIAL REPORTING

Employee benefits

Potential impact of the virus	Some of the things you should be thinking about
▶ Defined pension schemes will see a double impact because: ○ fair value of plan assets may decrease significantly; and ○ discounting of obligations may be less due to lower interest rates ▶ Termination benefits for employees will also need to be determined ○ with liabilities being recognised for such benefits.	▶ Termination benefits are recognised at the earlier of ○ when the benefit can no longer be withdrawn; and ○ when the entity recognises costs for a restructuring that is within the scope of IAS 37 or Section 21 of FRS 102 and involves payment of such benefits ▶ Offers cannot be withdrawn once communicated to the affected employees in sufficient detail ○ this is known as a constructive obligation.

Current position on accounting for 2019 bonuses that arise based on performance in the financial year and were waived due to a subsequent drop in performance are to be:

- accrued for in the year-end balance sheet unless there were clawback provisions; and
- credited to profit or loss in the subsequent year.

Current position on accounting for furloughed staff is:

- employment costs treated as expense (whether 80% or topped up amount)
- government contribution treated as government grant income
- under both IFRS and UK GAAP present gross in P&L, cash flow statement and balance sheet but can present net in P&L under IFRS

ACCOUNTING AND FINANCIAL REPORTING

Onerous contracts; Share-based payment compensation

Potential impact of the virus	Some of the things you should be thinking about
▶ ONEROUS CONTRACTS may exist for contractual or constructive obligations (e.g. purchase contracts for which no benefit will now be obtained by the entity) ▶ Insurance recoveries relating to losses incurred due to onerous contracts may not meet recognition requirements ○ as recovery may not be ‘virtually certain’.	▶ IAS 37 and Section 21 of FRS 102 do not permit recognition of future operating losses as liabilities ▶ However, losses arising from onerous contracts may increase as the unavoidable costs may exceed the economic benefits derived from the contract ▶ E.g. obligations to pay advertising costs after period-end with no clawback would be recognised as a liability at the time of cancellation as it would be onerous.

Potential impact of the virus	Some of the things you should be thinking about
▶ SHARE-BASED PAYMENT COMPENSATION SCHEMES require assessment of whether the satisfaction of certain types of vesting conditions have changed ▶ Modifications to share-based payment compensation schemes may need to be accounted for.	▶ Conditions may not be met ▶ Those that relate to service will result in ‘forfeiture’ accounting being applied, i.e. previously accumulated expenses recognised are reversed in profit or loss ▶ Market (e.g. target market price for the equity instruments) and other performance conditions (e.g. target to IPO within three years) do not result in forfeiture accounting if they are not met.

ACCOUNTING AND FINANCIAL REPORTING

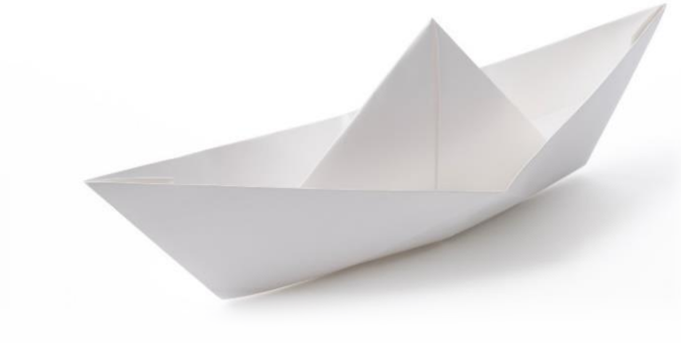
Income tax

Potential impact of the virus	Some of the things you should be thinking about
▶ Deferred tax assets arise when an entity has: ○ deductible temporary differences; and/or ○ unused tax losses ▶ These may not be recoverable in future periods ▶ And therefore may not meet the recognition criteria in IAS 12 or Section 29 of FRS 102.	▶ Entities will need to consider all available information to assess the ability to recover the value of: ○ deductible temporary differences; and ○ unused tax losses in subsequent reporting periods ▶ Cash flow forecasts will need to incorporate some severe 'down side' forecasts to account for disruption to operations ▶ Tax losses and deductible temporary differences with : ○ No fixed expiry date; or ○ A very long-term expiry date (e.g. 20 years) is not justification in itself for recognition. ▶ This thought process applies to both: ○ deferred tax assets currently on-balance sheet; and ○ those which potentially arise during the year.

ACCOUNTING AND FINANCIAL REPORTING

Fair value measurement

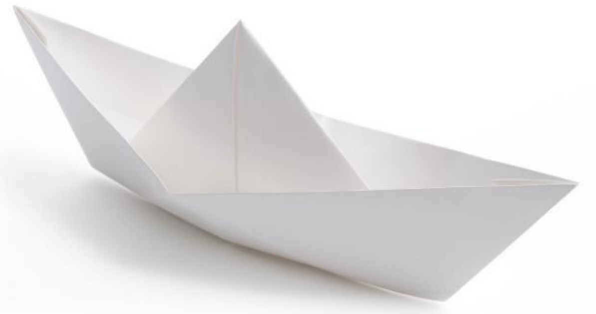
Potential impact of the virus	Some of the things you should be thinking about
▶ Challenge to **estimate the price that would be obtained** due to: ○ **highly volatile** markets; and/or ○ a **lack of an active market** ▶ Level in the fair value hierarchy for inputs into fair value measurements **may shift** ○ in particular from level 2 to level 3, **with associated enhanced disclosures**.	▶ **‘Distress sale’ market conditions** should be factored into fair value measurements ○ when a strategy of **not holding** the investment is being pursued ▶ Decline of activity in financial instruments with level 1 prices (quoted on an active market) **does not mean** that the price has become unobservable.



ACCOUNTING AND FINANCIAL REPORTING

Presentation of financial statements

Potential impact of the virus	Some of the things you should be thinking about
▶ Assets may no longer be consumed or realised in an entity's **'normal operating cycle'** ▶ Liabilities may become due on demand due to **breaches of contractual terms and covenants** ○ will result in their being **classified as current liabilities**.	▶ The classification of liabilities is **driven by rights** rather than an entity's expectation of the timing of settlement ▶ In contrast, a number of the criteria for current asset classification are **based around expectations** of when the asset will be realised or consumed ▶ Government fiscal measures may **mitigate** covenant breaches and lenders are being asked to **waive** covenants that relate to short-term illiquidity.



The effective date of "Classification of Liabilities as Current or Non-current (Amendments to IAS 1) (January 2020)" has been proposed to be deferred from 1 January 2022 to 1 January 2023 by the IASB.

ACCOUNTING AND FINANCIAL REPORTING

Non-current assets held for sale and discontinued operations

<table>
<tr><th>Potential impact of the virus</th><th>Some of the things you should be thinking about</th></tr>
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Sales of the following may not meet the ‘highly probable’ criteria to be classified as held for sale

non-current assets or disposal groups
This may be due to disappearance of an existing market and/or necessary buyers

Components disposed or ceased may meet the definition of discontinued operations

these require separate presentation and disclosure

Non-current assets or disposal groups that are not sold but are to be abandoned are not permitted to be classified as held for sale.

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Possibility that more assets may be classified as non-current assets held for sale if entities are required to liquidate certain assets
Also possible that there may be more discontinued operations as lines of business are exited.

</td></tr>
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ACCOUNTING AND FINANCIAL REPORTING

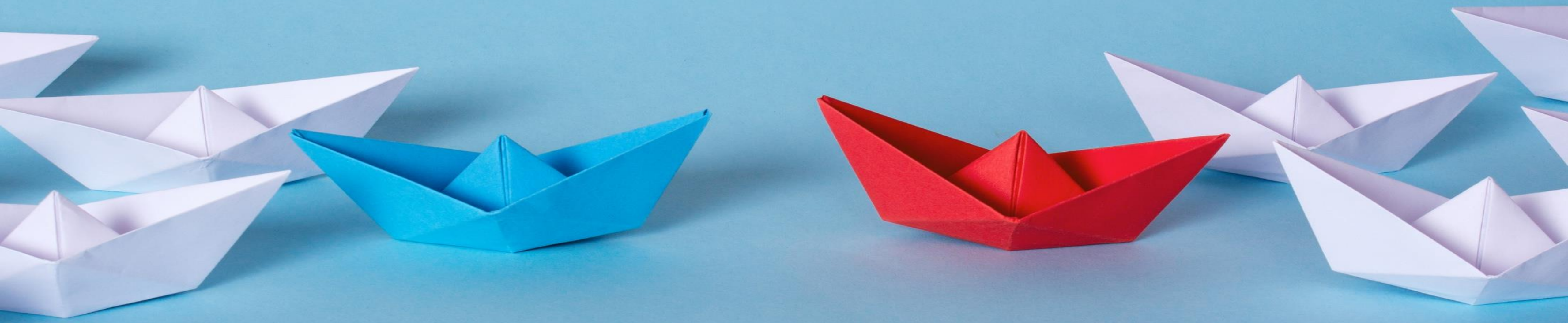
Financial instruments: Disclosures

Potential impact of the virus	Some of the things you should be thinking about
▶ Risks arising from financial instruments may require extensive disclosure ▶ Disclosure of the following may need to be expanded: ○ credit risk arising from financial assets (e.g. loans receivable, lease receivables, debt securities held, etc…) ○ liquidity risk, especially if a lack of liquidity may significantly impact the ability to operate ○ market risks where operations are significantly affected by changes therein (e.g. currency, interest rate and equity and commodity price risk) ▶ Disclosure of defaults and breaches of loans payable require disclosure surrounding the details of the default.	▶ Information that is already disclosed may need expanding on in both: ○ qualitative, and ○ quantitative terms. ▶ E.g. the basis on which sensitivity analysis has been prepared and the basis point shifts applied to the assumptions themselves ▶ This is to be done by material risk exposure ▶ Significant increases in multiple financial risks may exist, some of which may not have been significant in past financial statements.

ACCOUNTING AND FINANCIAL REPORTING

Interim financial reporting

- Entities to ensure they provide **significant disclosure** of the impact of the outbreak in their interim financial reports
- In accordance with the requirements of **IAS 34 and FRS 104**, entities preparing their first interim report for the annual period preceding the outbreak (e.g. 30 June 2020 for a calendar year-end) will need particularly comprehensive disclosures to provide **an understanding of the effect** of the virus on its financial reporting
- This includes consideration across both recognition **and** measurement
- Some impairments recognised in interim periods may be reversed at year-end (e.g. property, plant and equipment) but others may not (e.g. goodwill)
- Entities are to be cognisant of **reliefs** being offered in relation to the deadlines by which financial statements and other regulatory filings are required to be submitted.



CORPORATE REPORTING

FRC COVID-19 Guidance for companies

The Financial Reporting Council ('FRC') is the National Competent Authority for financial reporting (and auditing) in the UK

Corporate governance, MI and risk management

- Entities to ensure:
  - strong leadership, governance and mitigating measures are in place to address **the disruption to working practices and changing resource demands**; and
  - address **disruption to the usual flows of management information** ('MI') and how to maintain or complement this missing information

Dividends and capital maintenance

- Entities to ensure **availability of sufficient reserves if** dividends are to continue to be paid.

Alternative Performance Measures ('APMs')

- FRC's **thematic review findings** to be taken into account **when disclosing new APMs** that are introduced so to explain the effects of the virus on the business

Strategic report and viability statement

- Ensure the Strategic Report is forward-looking and **entity-specific**
- Disclose:
  - the specific resources, assets and relationships that have been considered to be **most under threat**; and
  - **mitigating actions** that have been implemented as a result
- Provide a '**reasonable expectation**' of the entity's viability over the period of assessment
- Be clear about the entity's **specific circumstances and the degree of uncertainty about the future**
- Draw attention to **any qualifications or assumptions** made in preparing the viability statement.

CORPORATE REPORTING

FRC COVID-19 Guidance for companies

Going concern and material uncertainties

- Significantly more difficult to assess given uncertainties, including the extent and duration of physical distancing measures, impact on the economy and asset prices
- Boards to consider:
  - potential impact of these matters on entity's specific circumstances;
  - access to government support measures that have been announced;
  - impact of different potential scenarios on revenues, costs (both fixed and variable) and cash flow needs;
  - if concludes there is not a material uncertainty that meets the disclosure criteria, but this conclusion required the application of significant judgement, then this judgement is to be disclosed
  - The latter is required by IAS 1.122 and FRS 102.8.6.

Significant judgements and estimation uncertainty

- Entities to provide as much context as possible for the assumptions and predictions underlying the amounts recognised in the financial statements, irrespective of any narrow interpretation of requirements
- Relevant judgements and assumptions are similar to those already outlined under "Boards to consider"
- Disclosures requirements on sources of estimation uncertainty are set out in IAS 1.125 and FRS 102.8.7

Events after the reporting date

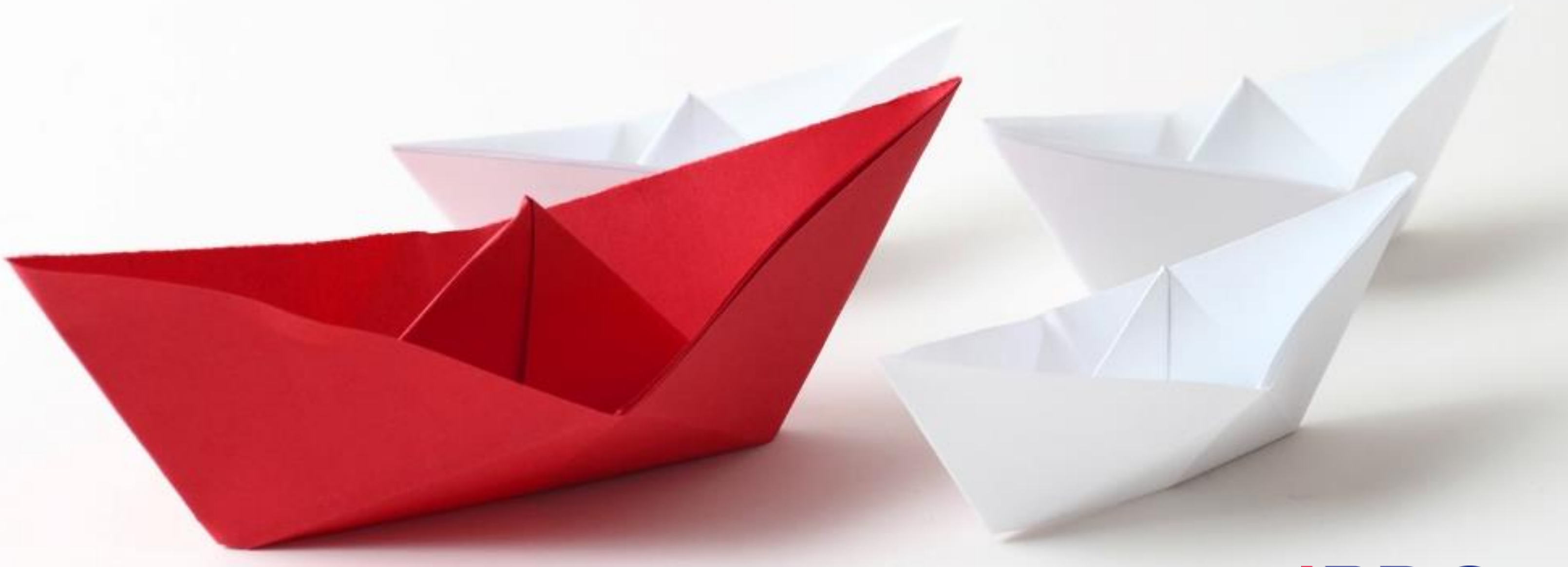
- Entities to judge how much of the impact of COVID-19 is considered to arise from non-adjusting events for subsequent reporting dates
  - Judgements with significant effect on the amounts reported are to be disclosed and explained
  - If an event is considered to be non-adjusting, then the nature of the event should be disclosed
  - Estimates of the financial effect on the entity or the inability to do so is to also be disclosed.

CORPORATE REPORTING

Annual entity accounts delay

- On the 26th of March 2020, FCA announced temporary relief on corporate reporting for **listed entities** subject to DTR 4.1 and via other listing rules (LR 9.2.6BR, LR 14.3.23R, LR 18.4.2R and 18.4.3R)
    - Additional 2 months provided to publish annual entity accounts (i.e. extended to within 6 months of year-end)
- Moratorium on the publication of **preliminary statements** ('prelims') **ended** on 5th April 2020
- Relief **also applies to debt securities** admitted to trading on a regulated market.

- On the 25th of March 2020, **Companies House** announced a **3-month extension period** to file annual accounts
    - This **needs to be applied** for in order to avoid penalties
- The FCA and PRA have also announced similar filing moratoria for **investment business**
    - i.e. **with a two month extension being granted**.



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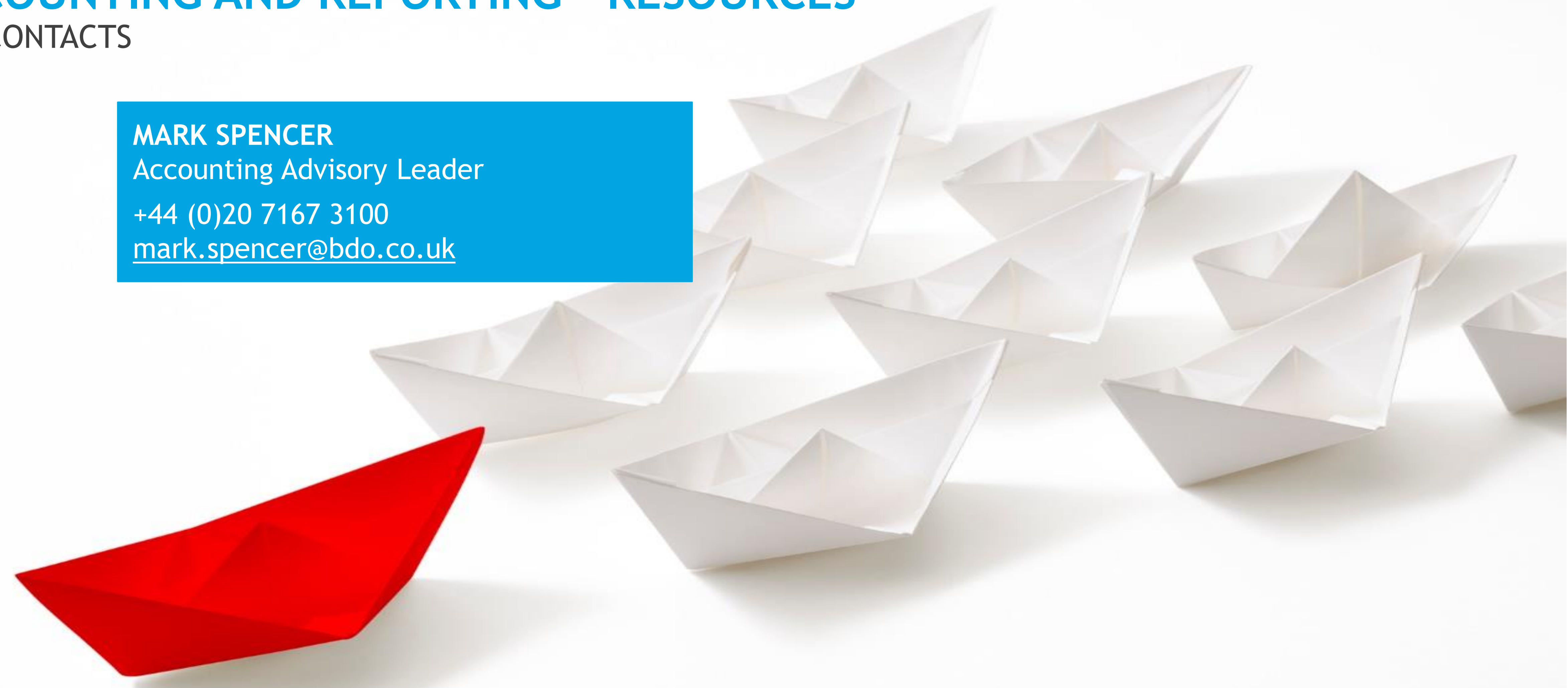

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- Upcoming Webinars
  - 1 June, 12:00 – 13:00, Reform and enhance culture: a practical approach
  - 26 June, 11:00 – 12:00, Five questions Boards should ask about cyber security

- 2020 Schedule
  - We have a full webinar listing on topics for Banking, Insurance and Investment Management
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