Deloitte.

Financial closing process in a Covid environment – November 2020

By David Waweru, Deloitte & Touche

MAKING AN IMPACT THAT MATTERS since 1845

Financial reporting summary

We have pleasure in providing in this document detailing our assessment of the COVID 19 pandemic on financial reporting

The coronavirus 2019 (COVID-19) pandemic is affecting economic and financial markets with entities experiencing conditions often associated with a general economic downturn. This includes, but is not limited to, financial market volatility and erosion, deteriorating credit, liquidity concerns, further increases in government intervention, increasing unemployment, broad declines in consumer discretionary spending, increasing inventory levels, reductions in production because of decreased demand, layoffs, and other restructuring activities. The continuation of these circumstances could result in an even broader economic downturn which could have a prolonged negative impact on an entity's financial results

Key accounting and financial reporting considerations related to COVID-19

The significance of the topics discussed will of course vary by industry and entity, but we believe that the following accounting and reporting issues will be the most pervasive and challenging as a result of the pandemic's impact:

Preparation of forward-looking cash-flow estimates

- There is an extremely wide range of possible outcomes. There is a particularly high degree of uncertainty about the ultimate trajectory of the pandemic and the path and time needed for a return to a "steady state."

- The associated economic impact of the pandemic is highly dependent on variables that are difficult to predict. Examples include the degree to which governments restrict business and personal activities, the associated level of compliance by citizens, the degree to which "flattening the curve" is successful, and the nature and effectiveness of government assistance.

- Each entity must then translate the effect of those macro conditions into estimates of its own future cash flows.

Recoverability and impairment of assets — Perhaps the most acute examples of the increased challenge associated with forward-looking information are the impairment tests for long-lived assets, intangibles, and goodwill. These nonfinancial assets use recoverability and impairment models that rely on the development of cash flow projections that are subject to the significant uncertainties.

Accounting for financial assets — Recently, there have been severe declines in the fair value of many financial assets, particularly equity securities. Likewise, the ability of debtors to comply with the terms of loans and similar instruments has been adversely affected. Entities will need to carefully consider and apply the appropriate impairment and loss recognition guidance.

Contract modifications — Changes in economic activity caused by the pandemic will cause many entities to renegotiate the terms of existing contracts and arrangements. Examples include contracts with customers, compensation arrangements with employees, leases, and the terms of many financial assets and liabilities. As a result of these changes, entities will need to ensure that the appropriate guidance in IFRS is considered.

Going concern — As a result of COVID-19 and its associated effects, entities need to consider whether, in their specific circumstances, they have the ability to continue as a going concern within one year after the date on Going concern considerations, Liquidity and convent disclosures, significant assumptions

Financial reporting focus areas for 2020

Significant judgements and estimates

Our focus is on encouraging companies to provide detailed disclosures of the accounting judgements and sources of estimation uncertainty in respect of their financial statements,

Fair value measurements

IFRS 13 ‘Fair value measurement’ sets out the framework for fair value measurement for both financial and non-financial assets and liabilities. It requires the disclosure of the significant assumptions, valuation techniques and inputs used to measure the fair value. In particular, where the fair value measurement requires the use of significant unobservable inputs (level 3), more judgement must be exercised in determining fair value and the disclosure requirements are more detailed

Presentation of financial statements

IAS 1 requires companies to present additional line items and sub totals, which are comprised of line items made up of amounts recognised and measured in accordance with IFRS on the face of the income statement, if the presentation of such subtotals and line items aids a user’s understanding of the company’s financial performance.

Management will need to consider whether additional items of income and expenditure arising from the Covid-19 crisis should be separately disclosed in accordance with their existing policies for ‘exceptional’ or similar items

Dividends and capital management

Where dividends have been suspended, it is helpful to indicate when the period of suspension is expected to end

Expected credit loss provisioning

The IFRS 9 expected credit loss model (ECL) requires the use of reasonable and supportable forward looking probability-weighted information in addition to the historical data. IFRS 9 requires an unbiased expected credit loss provision, neither overly optimistic nor overly pessimistic.

- changes to their credit risk management in response to Covid-19; concentration of credit risk;
- how forward looking information was incorporated in the ECL measurement;
- any significant adjustments made by management to the impairment figures and models;
- and key sources of estimation uncertainty

Strategic Report

Business review –Operational & financial impact historical and current year, principal risks and uncertainties , impact on strategy and business model

Financial reporting other focus areas

What message or discussions we need to start having across board with all stakeholders

01 Going concern-IAS ISA 570 IAS1:25 & 26

- Given the current uncertain environment we expect company specific going concern disclosures to explain clearly the key assumptions and judgments that the board has made
- Business review and strategic report
- We also expect disclosure of possible scenarios that could lead to failure and details of any mitigating actions available
- Any post balance sheet changes to liquidity, new lending facilities, extensions or renegotiation, level of undrawn and drawn facilities
- Any structural changes needed to continue as a GC

02 Cash, Liquidity and Covenant compliance

IFRS 7 financial instruments: Disclosures' requires disclosure of sufficient information about the nature and extent of the company's risks exposures from FI, including liquidity risk. Disclosures about sources of liquidity, risk exposure and the steps that the company is taking to mitigate their liquidity risk is critically important in the current environment. We expect engagement teams to re-check the clients'

- Boilerplate disclosures on liquidity risk and sources of finance
- Their access to cash and other sources of funding
- Any changes or likely changes to existing finance
- Any new arrangements entered into

This should be consistent with the GC statement

03 Significant judgments & Estimates -ISA 540, IAS1:125

Judgements and estimates is an areas of reporting which historically, has given a number of questions.

IAS 1 para 125 requires an entity to disclose the assumptions it makes about the future, and other major sources of estimation uncertainty that have a significant risk of resulting in material adjustment to the carrying amount of assets and liabilities within the next financial year.

As part of **risk assessment**, we should consider whether there are any indicators of management bias

ISA 540 requirements on audit teams to document **accuracy and completeness of data**, methodology and assumptions used by management.

Financial reporting focus areas 2020

Key areas

Other financial reporting key areas

01

Provisions and onerous contracts

Management's actions in relation to the impact of the Covid-19 crisis should only be accounted for as a provision to the extent that there is a present obligation for which the outflow of economic benefits is probable and can be reliably measured. (IAS 37 'Provisions, contingent liabilities and contingent

We expect management to clearly disclose the nature of the obligation and the expected timing of the outflow as well as to disclose any significant judgements or estimates in cases where Covid-19 related provisions have been recognised. Disclosure of any uncertainties about the amount or timing of cash out flows should also be provided.

02

Adjusting and non-adjusting post balance sheet events

When preparing accounts, consideration will need to be given as to whether there are any post balance sheets events which provide evidence of conditions existing at the period end which must be reflected in the period end financial statements. This assessment must be made without the benefit of hindsight to ensure assets and liabilities recognised at the period end reflect the conditions as at the period end.

As the Covid-19 pandemic is made up of a series of events, consideration will need to be given to which of these events fall to be classified as adjusting and how these adjusting events should be recorded in the financial statements. This is likely to require continual assessment of the changing circumstances that the company faces and whether they meet the IAS 10 paragraph 3 definition of adjusting events as at their year end.

03

Employee Benefits- Covid-19 may result in companies amending the terms of employee remuneration schemes such as share based payments. We expect management to account for any scheme amendments or curtailments in accordance with the guidance in IFRS 2 'Share-based payments' and we expect any such changes to be appropriately described and disclosed.

Impairment of non-financial assets

IAS 36 –Impairement of non-financial assets covid 19 focus

Over view of IAS 36

IAS 36 Seeks to ensure that an entity's assets are not carried at more than their recoverable amounts(RA)

Recoverable amount

Recoverable amount is higher of Fair Value less costs disposal and Value in Use

Fair value

FV -If we are to sell the asset at date of sale how much =100m, costs to dispose of the asset = 5m , Fair value= 95

Value in Use

Present value of the future cash flows expected to be derived from use of an asset or Cash generating unit

VIU -Uses expected cash flows discounted to get present value- these are subjective as they are based on budgets and forecast – (Areas of estimation uncertainty and judgement)

How frequent should entities conduct the tests?

- Goodwill and certain Intangible assets … Tests on an annual Basis BUT all other assets like Property, Plant and Equipment –whenever there is an indicator of impairement ,

Entities will need to assess whether the impact of COVID-19 has potentially led to the impairment of assets that are covered by IAS 36 Impairment of Assets.

The financial performance of an entity, including estimates of future cash flows and earnings, may be significantly affected by the direct or indirect impacts of recent and ongoing events relating to the COVID-19 pandemic.

Indicators of impairement-covid 19

Internal and external indicators of impairement

- Some assets becoming idle i.e. reduction in demand from customers due to covid-19;
- Physical damage due to prolonged time to use the assets;
- Restructure or plans to restructure the operation to which the asset belonged as result of covid-19
- Subsequent cash needed to maintain or operate the assets after lockdowns
- Increased costs of business or business interruptions due to supply chain issues.
- Cancellation or postponement of orders by customers
- Significant customers experiencing financial difficulties or cash flow difficulties.

Financial Reporting considerations

IAS 36 Impairment of Assets-covid-19 Impact

In these uncertain times, management may face significant challenges in preparing the budgets and forecasts necessary to estimate the recoverable amount of an asset (or CGU).

Management may determine that using an expected cash flow approach is the most effective means of reflecting the uncertainties of the COVID-19 pandemic in its estimates of the recoverable amount. This approach reflects all expectations about possible cash flows instead of the single expected outcome.

Key principles to note:

1. Estimated cash flows and discount rates should be free from both bias and factors unrelated to the asset in question.

2. Estimated cash flows should reflect a range of possible outcomes, rather than a single expected outcome.

3. Cash flow projections should reflect the conditions in existence at the reporting date and be based on the most recent financial budgets/ forecasts, approved by management at the appropriate level of authority, covering a maximum period of five years, unless a longer period can be justified. In these uncertain times, reliable detailed budgets may only be available for a shorter period

Key principles to note (continued):

4. Projections of cash flows beyond the period covered by the most recent budgets / forecasts should be estimated by extrapolating the projections based on the budgets/ forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified based on objective information about patterns over a product or industry lifecycle.

5. Future cash flows should be estimated for the assets in its current condition and should not include estimated future cash inflows or outflows expected to arise from improving or enhancing the asset’s performance or future restructuring to which the entity is not yet committed.

6. The entity’s weighted average cost of capital (WACC) can be used as a starting point for estimating a market discount rate, but this should then be adjusted to reflect the way the market would assess the cash generating unit’s cash flows (unless that risk is already included into the estimated cash flows).

7. Care should be taken as to consistency of data being prepared and compared to avoid double counting or omission of some data.

I

IFRS 16 Leases & Covid-19-related rent concessions

IFRS 16 Leases –Covid-19-related rent concessions

Summary

The IASB issued *Covid-19-Related Rent Concessions*, which amends IFRS 16 Leases, to simplify the accounting of Covid-19-related rent concessions by lessees. Due to Covid-19 many lessors have granted rent concessions to their lessees. In the first part of this publication we analyse the challenges lessees and lessors may face when accounting for these concessions, and the IASB's response in alleviating some of them.

Background

- Due to the impact of Covid-19, many lessees are being offered **rent concessions** by their lessors.
- Rent concessions may take different forms, such as **rent deferrals or rent holidays**.
- IFRS 16's definition of a **lease modification** includes a change in the consideration for a lease.

What challenges would modification accounting create for lessees?

- Lessees may find difficulty in **determining** whether their specific rent concessions are **lease modifications or not**.
- To account for the modification of a lease, a **revised liability** (and corresponding **adjustment to the right-of-use ("ROU") asset**) needs to be calculated
- This involves using a **revised discount rate**, which creates operational challenges for many lessees (especially in the Retail sector).
- Additionally, if current discount rates are lower than historical rates this could lead to a **larger liability** despite the rent concession (and an increased ROU asset, which is then subject to the impairment considerations discussed later).
- Many lessees, especially in the Banks, Retail, Hospitality and Leisure sectors, have a **large volume of leases** that may be affected.

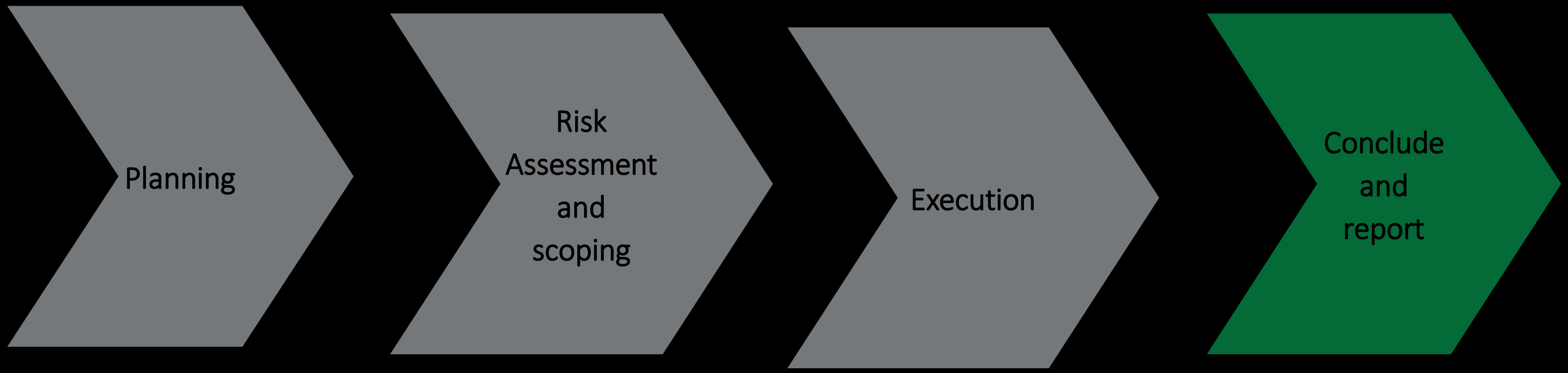
Qualifying Criteria?

Qualifying criteria for applying the practical expedient

- The rent concession needs to be a **direct consequence of Covid-19;**
- The **revised consideration** for the lease is **substantially the same as, or less than**, the consideration for the lease immediately preceding the change;
- Any **reduction** in lease payments affects **only payments originally due on or before 30 June 2021** (even though subsequent increases can fall beyond that date); and
- There is no substantive change to other terms and conditions of the lease.

Reaping maximum benefits from the audit process

The Audit Process



Key to successful audit

- Early planning and identification of audit issues
- Ongoing open communication
- Timely financial closing including components for Groups
- Addressing significant issues early in the audit for example:
  - Areas requiring significant judgment and estimates
  - Complex account balances and transactions
  - Revenue
  - Significant unusual transactions during the year
  - Significant related party transactions
  - Going concern uncertainty

This allows for value adding engagement with the auditors early in the audit

Key to successful audit (Continued)

- Experts – Identification of management experts early and agreement on scope of work
- Appraising the entire C Suite and Those Charged with Governance on audit progress and issues arising from the audit.
- **ROBUST SYSTEM OF INTERNAL CONTROL**

Understanding audit opinions

- Clean/unmodified opinion
  - May or may not contain Key audit Matters
  - May or may not have a going concern material uncertainty section.
- Qualified opinion- Except for opinion
- Adverse opinion
- Disclaimer of opinion

- Note for ISA audit of general purpose financial statements- Auditors issue opinion on financial statements and report other audit findings not impacting the opinion in a separate report to management.