Implications on financial statements

As the potential impacts of the outbreak continue to evolve rapidly, it is vital that you monitor the situation right up to the date your financial statements are authorised for issue.

Amounts recognised in the financial statements are adjusted for conditions that existed at the end of the reporting period. No adjustments should be made for conditions that arise after the reporting period (regardless of the valuation methods used or the fair value hierarchy), unless they impact the going concern assumption. This assessment may require significant judgement for reporting periods ending after 31 December 2019. Further volatility in the markets will make fair value assessments more challenging and additional evidence may need to be collated and evaluated.

You will need to carefully consider the facts and circumstances affecting your organisation and document your decisions as soon as possible. Potential areas to consider include:

1 Assessment of conditions – should adjustments be made (or not)?
   1.1 Reporting periods ended on 31 December 2019
   1.2 Reporting periods ending after 31 December 2019

2 Going concern

3 Judgements and accounting estimates that impact recognition and measurement of assets
   3.1 Impairment of non-current assets, including goodwill
   3.2 Fair value measurement
   3.3 Net realisable value of inventory

4 Recognition and measurement of liabilities
   4.1 Provisions for onerous contracts
   4.2 Provisions for restructuring and redundancies

5 Hedge accounting

6 Current tax and deferred tax

7 Revenue recognition

8 Disclosure
   8.1 Non-adjusting subsequent events
   8.2 Significant judgements and estimates
   8.3 Other disclosures

Key focus areas – more detail

1 Assessment of conditions – should adjustments be made (or not)?

Two types of events occur between the end of a reporting period and the date when the financial statements are authorised for issue:

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 key here is to determine the underlying causes and timing of event(s) and circumstance(s) that have an impact on financial statements.

1.1 Reporting periods ended on 31 December 2019

Although the COVID-19 existed at 31 December 2019, significant changes in business activities and economic
conditions occurred as a result of events occurring after the balance sheet date, such as actions taken by the government and private sector to respond to the outbreak.

Generally, the outbreak is a non-adjusting event for the reporting period ended on 31 December 2019 and no adjustment needs to be made to amounts recognised in the 31 December 2019 financial statements.

1.2 Reporting periods ending after 31 December 2019

As events unfold and more information becomes available the impact on various estimates, which depend on future forecasts, could become apparent. Given asset and liability values are currently highly volatile and markets are reacting to large volumes of uncertain information and adjusting expectations rapidly, it may be difficult to assess whether movements in values of assets and liabilities occurring after reporting date are adjusting or non-adjusting events.

In preparing your financial statements one of the challenges going to be assessing whether, given the volatility in the market, changes in values relate to events that existed at the end of the reporting period, or whether they arose subsequently. This may require changes to year-end processes to collate and assess relevant information.

2 Going concern

When assessing whether an entity is a going concern, all relevant information available up to the date the financial statements are issued must be considered. Events that occurred after the reporting date to respond to the outbreak could have caused a significant deterioration in economic conditions for some entities, and an increase in economic uncertainty for others.

This means that you may need to assess whether these events or conditions, individually or collectively, cast significant doubt on your organisation’s ability to continue as a going concern, or in severe cases, whether the going concern assumption is still appropriate as a basis for the preparation of your entity’s financial statements. If the conclusion is that the consequences of the outbreak have led to a deterioration in operating results and/or financial position after the reporting date that is so severe that the going concern basis of preparation is no longer considered appropriate, the financial statements would need to be adjusted.

3 Judgements and accounting estimates that impact recognition and measurement of assets

3.1 Impairment of non-current assets, including goodwill

— The impact of COVID-19 on an entity and its industry may be an indicator of impairment and trigger an increase in the frequency of impairment testing and impairments recognised.

— The increased uncertainties inherent in the cash flows may be reflected by either adjusting the cash flows or the discount rate.

— If you apply the value in use (VIU) model, the cash flows should represent your best estimate of the range of economic conditions that will exist over the life of the asset. These need to be reasonable and supportable with greater weight given to external evidence. In the current environment it may be difficult to forecast cash flows with confidence, which may lead to greater reliance on the fair value less costs of disposal model (FVLCOD).

— The discount rate used in the VIU calculation should reflect market participants’ assumptions, including their assumptions about risk. These assessments should be made with reference to observable market data points. Current market volatility provides some indication about the market’s perception about risk and uncertainty.

— VIU should be cross checked against either a market capitalisation reconciliation or earnings multiples implied by the VIU valuation. These cross checks are referenced to observable market data which reflect the current conditions.

— If you adopt a FVLCOD model for your impairment testing, the points noted in the following section (3.2) will need to be considered.

3.2 Fair value measurement

— The objective in estimating fair value is to determine the price at which an orderly transaction would take place between market participants at the measurement date under current market conditions.

— You will need to evaluate the circumstances to determine whether, on the weight of evidence available, the transaction is orderly.

— Volatility may raise questions as to whether current pricing is reflective of fair value. However, the standard does not permit current market evidence to be dismissed on the basis of volatility alone.

— Some may argue that in the current environment there is an element of forced selling and that fair value measurement is not intended to reflect prices in a forced or distressed sale. Nevertheless, the presence of distressed or forced sellers in a market may influence the price that could be obtained by a non-distressed seller in an orderly transaction.

— The intention of a fair value measurement is to consider all the evidence available about the current conditions, rather than a price that could be achieved in the future.

3.3 Net realisable value of inventory

— Net realisable value (NRV) of inventory may decrease if, for example, there is a reduction in demand for goods with short shelf lives, or, goods expire because items used in conjunction with these goods cannot be obtained.

— Sales and purchase contracts may be unable to be fulfilled resulting in excess inventory, in turn affecting NRV.

3.4 Impairment of financial assets / Expected credit losses

— Expected credit losses (ECLs) may increase.
ECLs should reflect all reasonable and supportable information about the outbreak that are available up to the reporting date.

The outbreak will most likely affect forward looking aspects of the ECL calculation (e.g. banks will need to consider the impact of significant increases in Credit Risk or probability weighted outcome of the ECL model as these rely on forward looking information).

Consider segmenting customers into subcategories affected by the outbreak and the impact on the ECL model.

No adjustment for new information received after the reporting date would usually be appropriate unless the new information indicates that there was a failure to consider appropriately all reasonably available information at the reporting date.

### 3.5 Deferred tax assets

The recoverability of deferred tax assets may be impacted by changes to future forecasts.

### 3.6 Insurance recoveries

If you have insurance policies in place you may be able to recognise an insurance receivable. However, you will need to determine that the policy is valid, covers the losses incurred, is in place at end of the reporting period; and the claim is not disputed by the insurance company.

If the amount of the claim is yet to be agreed with the insurance company, estimation of amounts expected to be received should be based on conditions that existed at the end of the reporting period.

### 3.7 Government grants and assistance

A government grant (excluding tax measures described in section 6 below) is not recognised until there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received.

### 4 Recognition and measurement of liabilities

#### 4.1 Provisions for onerous contracts

Customer contracts may become onerous if, for example, suppliers are unable to fulfil their obligations under the contract as a result of closure or reduced production by manufacturing plants.

The existence and enforceability of force majeure clauses in contracts may impact the assessment of whether contracts are onerous.

#### 4.2 Provisions for restructuring and redundancies

A provision for restructuring costs is recognised only when the general recognition criteria for provisions are met by the end of the reporting period.

In order to recognise a provision for restructuring (constructive obligation) you will need to have made an announcement of the restructure with enough detail on or before the end of the reporting period.

Similarly, a provision for possible redundancies is recognised if, at the end of a reporting period, you have made an offer and that offer cannot be withdrawn, or the restructuring involves redundancy payments.

### 5 Hedge accounting

The determination of whether forecast transactions such as foreign currency cash flows or debt drawdowns / repayments are highly probable may be affected. For example, the closure of manufacturing plants may affect the assessment of whether sales or purchases are highly probable. Alternatively, revised plans for capital expenditure due to a struggling tourism industry may affect the estimated future debt levels.

The impact of such uncertainty on forecast transactions could render the hedges ineffective, resulting in the changes in fair value of derivatives hedging instruments being recognised in profit or loss or the hedge relationship being terminated.

### 6 Current tax and deferred tax

Current tax and deferred tax should be measured using tax laws that have been enacted or substantively enacted by the end of the reporting period.

Entities need to monitor the status of the government’s proposed changes to New Zealand tax law. The new legislation is expected proceed under Parliamentary Urgency to ensure prompt enactment.

### 7 Revenue recognition

The likelihood of penalties in revenue contracts being incurred may increase for example due to delays in obtaining supplies for projects. You will need to assess judgements around the recognition of variable consideration with a focus on the impact of delays in satisfying performance obligations.

### 8 Disclosure

#### 8.1 Non-adjusting subsequent events

As noted above you must consider whether the non-adjusting events or conditions related to the COVID-19 arising after the reporting date are material (besides implications of going concern). If material, you need to disclose the nature of the event and an estimate of its financial effect or a statement that an estimate cannot be made in its financial report. This may be challenging in the current environment and will need to be carefully planned and assessed. Non-adjusting events after the reporting period are material if non-disclosure could influence the economic decisions that users make using the financial statements.

#### 8.2 Significant judgements and estimates

Disclosure will be important for entities with exposure to COVID-19 related uncertainties as the impacts involve significant judgement. Relevant disclosures include:
Identifying key assumptions made about the impact of COVID-19 on material estimates.

Highlighting sources of estimation uncertainty that could result in material adjustments to the carrying amount of assets and liabilities, including sensitivity analysis or a range of outcomes.

**8.3 Other disclosures**

Debt arrangements may need to be reviewed to determine if there are any loan defaults or if any loan covenants are breached, and require disclosure, as a result of any adjustments to the financial statements.

Other considerations are:

- The status of financing negotiations and the impact it will have on the classification of debt as current vs non-current on the balance sheet.
- Updating the disclosures on the entity’s strategy and policy around managing risk to assist the user in understanding the risks faced by the entity (e.g. business risk, market risk, operational risk, etc)
- Fair value – disclosures of the changes in the economic environment that will have an impact on the fair values of financial assets and financial liabilities.
- Any waivers extended on instruments that require disclosure or would impact on the classification and measurement of financial assets.
- The impact of the volatility in commodities and/or foreign currency exchange markets on the financial statements.
- The impact on sensitivities particularly in respect of sensitivity analysis and maturity analysis disclosures.
- The impact on the assumptions made when classifying non-current assets as held for sale (e.g. will the sale still be highly probable).

**Further information**

Further information on the financial reporting impacts of COVID-19 can be found [here](#). As the situation evolves we will be releasing more guidance. Please watch this space.

If you have any questions on the above, please contact KPMG’s Accounting Advisory Services Team or your regular KPMG contact.

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